AN INTRODUCTION TO BANKING PRINCIPLES, PRACTICE & LAW

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PREFACE TO THE SECOND EDITION

In this edition, I have brought facts and figures up-to-date and replaced Chapter XXII by a new one, entitled 'Post-War Developments'.

B. C. G.

PREFACE TO THE FIRST EDITION

I have attempted in this book a fairly complete introduction to the principles and practice of banking. The book is intended primarily as a text-book for B. Com. students. I do not know of any single book on 'Banking' which adequately satisfies the requirements of the B. Com. syllabus of most Indian universities. This syllabus is fairly wide and usually covers not only the general principles of banking, but also Indian banking and the money market of India and the monetary systems of important foreign countries as well as banking law and practice. Another handicap for Indian students which I have noticed while lecturing to them in the B. Com. classes is the absence of a text-book which illustrates banking theory or practice by reference to Indian conditions. Practically all our text-books are either British or American, and they naturally refer for illustration of any point to conditions in Britain or the U. S. A. In this book, I have attempted to explain banking theory and practice by reference to Indian conditions as well.

This book is divided into four parts, namely, general banking principles, the monetary systems of the U. K., the U.S.A., France and Germany, Indian banking and the money market of India, and banking practice and

law. I have thus covered a very wide range of subjects in a short compass, and this has of necessity involved a considerable amount of compression. This, I hope, will not detract from the value of this study as a general exposition of the principles and practice of banking. I should also like to emphasize that this book, as its title implies, provides only an introduction to the subject, and readers should follow up their study by reference to standard works on the various subjects dealt with in this book.

This book is essentially one of exposition and not of research. In writing it, I have freely consulted and borrowed ideas from existing literature on the subject. For the convenience of readers, I have added at the end of the book a short bibliography.

Although primarily meant for B. Com. students, this book will, I hope, be found useful for students preparing themselves for the Indian Institute of Bankers' examination as well as for the general reader.

B. C. G.

PART I

GENERAL BANKING PRINCIPLES

CHAPTER I

MONEY AND BANKING

MONEY and banking, observes Professor Marshall, is the 'centre around which all economic science clusters'. In truth, it need hardly be emphasized that the efficient working of the economic mechanism is impossible in the absence of satisfactory monetary arrangements.

In any economic system, money subserves two principal functions—the function of acting as a medium of exchange and the function of acting as a standard of value or, as is sometimes stated, as a common denominator of value. There is yet another function of money, namely, that of acting as a store of value; and this function may at times become of great importance.

A common denominator of value or an instrument of comparison is essential in a modern society in view of the great variety of products and services that is offered in the market for sale, and which competes for the attention of the consumers as a whole. It would be impossible, given the complexity of the productive processes of modern societies and the multitude of choices open to individuals, to compare alternatives, unless comparison were made easy. Money provides such a method of comparison. It is necessary, further, that there should be something which has a physical embodiment, that is, a medium of exchange, so that it can pass from hand to hand in exchange for goods and services. The common denominator thus physically embodied is known as currency.

Every modern community must provide its citizens with an adequate supply of media of payment. This may be

done through the issue of token coins and paper money or notes. The issuing authority may be the government, the central bank or some other institution. In most countries, token coins are issued by the governments and currency notes by central banks. There is, however, no uniformity of practice in all countries and the conditions governing the issue of notes vary in different countries.

The provision of currency solely in the shape of coins and notes can no longer meet the monetary requirements of modern society. Coins and notes have been supplemented by the employment of the cheque or instruments analogous to it. Such instruments can be drawn only on financial institutions of the nature of banks and on condition that the drawer has a right to draw, which usually means the possession of a bank balance subject to cheque. Such a balance can be obtained either by saving out of income or by a loan from the bank itself.

There is thus an intimate association between the banking system and the monetary mechanism. In certain countries, the banking system provides part of the ordinary circulating medium in the shape of bank notes. Historically the right of note issue and the practice of banking were intimately linked together. In modern times, when notes are issued by banks at all, they are the concern of a particular type of bank known as the central bank. The right of issuing notes is no longer regarded as part of the specific functions of the commercial banking system.

The real functions of the commercial banking system begin with the facilities it offers to the public for the safe custody of its money. When an individual's current income is larger than his current expenditure, he has a cash balance, the safeguarding of which becomes an important problem. The larger the cash balances, whether of indi-

viduals, corporations or public agencies, the more acute is this problem. Banks and financial institutions relieve the public of great anxiety by receiving such balances for safe custody withdrawable on demand or on conditions mutually agreed upon. In the seventeenth century in England, when the goldsmiths functioned as bankers, they used to charge a commission for the safe custody of money deposited with them by customers. But experience soon showed that only a small proportion of the funds so deposited was required to meet current withdrawals. The balance of the funds could be lent out at interest. As this proved a profitable business, the more enterprising among the goldsmiths began to offer interest as an inducement for depositing money with them. The interest so offered was, of course, lower than the rate charged for loans. It is on the same principle that banks are able to pay interest on money deposited with them. Experience has shown that under normal conditions, when there is no reason to distrust the monetary policy of the country or the soundness of its banking administration, only a small proportion of the deposits placed with banks is liable to be withdrawn. The banker is therefore in a position to advance a large proportion of the funds entrusted to him to those who can pay for the temporary use of this money.

This ability to loan a considerable portion of the funds entrusted to bankers by their depositors invests these institutions with a peculiar trait of far-reaching significance in the economic system. As Sayers[1] observes, 'banks are not merely purveyors of money, but also, in an important sense, manufacturers of money'. As manufacturers of money, banks naturally influence the volume of purchasing power in the hands of the public, and therefore the price level.

[1] *Modern Banking*, p 1.

Let us examine for a moment the way in which a bank is enabled to manufacture money. It has already been explained that a banker need not keep in his vaults all the cash that he receives on deposit, but is able to loan a considerable portion of it. When a borrower has convinced his banker of his credit-worthiness and has persuaded the banker to lend him, say, one thousand rupees, either of two things may happen. He may take out the proceeds of his loan in cash, in which case the banker's total deposit will remain the same, while cash assets will decline and other assets will increase. The banker will have changed a cash for a non-cash asset. Alternatively, instead of taking out the loan in cash, the borrower may leave the amount in deposit with the banker. This would swell the bank's deposits as a whole, leave its cash unaffected, and add to the non-cash assets an amount equal to the amount of the loan. The same consequence would follow if, instead of granting a loan, the bank were to purchase securities with its own money. The seller would receive a cheque from the bank in payment of the securities, and might either draw out cash or leave the proceeds of the cheque in deposit with the bank. When the borrower of a loan or seller of securities does not draw out cash from the bank, but leaves the proceeds in deposit with the bank, he helps to swell its deposits. This is what is understood by the old banking maxim: 'loans create deposits'. In fact, the large increase in banking deposits in this or any other country in recent times is mainly the result of loans granted and securities purchased by banks.

ONS OF

Although bank loans may, and in fact do, help to expand deposits, it should not be supposed that banks are unfettered in their powers of increasing the total of bank deposits, that is, in 'creating credit'. It is obvious that the

money a bank 'creates' or 'manufactures' is its liability. It is liable to pay it in cash. The banker's ability to 'create' money depends upon the fact that he is not called upon to meet all his liabilities in cash. But his depositors will require some amount of cash, which he will have to pay out. The public requires a certain amount of hard cash for its daily transactions, which it will draw from banks. Thus, the banks are obliged to keep themselves supplied with a certain proportion of the cash entrusted to them by their depositors in order to be able to meet their demand for cash. The cash reserve that they have to maintain, whatever may be its size, thus imposes a limitation on their power to 'create' money at will. The nature of the limitation will naturally depend upon the magnitude of the cash reserve that they consider it safe and prudent to maintain. In Great Britain, for example, experience has shown that banks should not let their cash reserve fall below 9 or 10 per cent of their total deposits. In India, a larger cash reserve should be considered necessary inasmuch as the cheque habit is not so developed in this country as in Great Britain. Indian banks in fact maintain a cash of between 10 and 15 per cent. If, again, the public in any country holds a larger proportion of available cash in its own hands, the amount of cash that will find its way to the banks will be smaller with the result that the banks' ability to expand credit will be correspondingly reduced. Thus, the total bank deposits may be said to depend on three things, namely:

- (a) the total amount of cash in the country,
- (b) the amount of cash which the public wishes to hold,
- (c) the minimum percentage of cash to deposits which the banks consider safe.

There is yet another limitation on the banker's power to

'create' credit, the availability of sound assets. The banker does not create money out of thin air. He merely exchanges his I.O.U.'s in the shape of bank deposits with a right to draw cheques for certain forms of assets, for example, securities, buildings or bills of exchange. Even when a loan is granted without any tangible security, for example, against the personal security of the borrower, it is the earning capacity of the borrower, which is a form of wealth, that constitutes the security. Thus, what the banker does is to transmute other forms of wealth into money. The banker 'takes the immobile wealth as his asset and gives his I.O.U. (which is money) in exchange. This is the very essence of the banker's business'[1].

It is, however, often contended that banks do not create money. They simply lend money entrusted to them by their depositors. Bankers argue that even if a bank granting a loan of Rs 1,000/- has to maintain a cash reserve of only Rs 100/- or Rs 150/-, it will be losing cash to other banks in the locality in view of the fact that cheques drawn upon it in respect of the loan granted will in all probability be deposited with these other banks. But this argument overlooks two facts: one theoretical and the other practical. In the first place, if the bank granting a loan loses cash to other banks, these other banks will have their cash increased. This will enable them to increase their deposits, that is, to create credit, and our original bank will in all probability receive some portion of the cash it lost to the other banks. Further, if the extra cash of Rs 100/- or Rs 150/- on the basis of which our original bank expanded its deposit by Rs 1,000/-, has come from outside the banking system, for example, by the importation of gold, there will be

[1] Crowther: *An Outline of Money*, p. 47.

additional cash to the value of this amount in the banking system, and the process of deposit expansion will continue until Rs 1,000/- worth of extra deposit has been created. In the second place it is an actual fact that the deposits of banks are many times their cash reserves. Thus, on December 27, 1946, the deposit and time liabilities, that is, the total deposit of all scheduled banks in India and Burma amounted to Rs 1061 crores while their cash in hand amounted to Rs 48 crores and the balances with the Reserve Bank of India to Rs 69 crores ; that is, the total cash reserve added up to Rs 117 crores. Thus, the total deposits of these banks as on this date were over nine times their cash reserves. There can, therefore, be no doubt that banks can and do create money. But there is a practical limit set upon their power to do so by the amount of cash available, and the proportion they have to maintain as a reserve.

CHAPTER II

TYPES AND CLASSES OF BANKS

DIFFICULTIES OF CLASSIFICATION

A CLASSIFICATION of financial institutions presents many difficulties. For one thing, there can be no uniform classification of such institutions applicable to all countries. Economic conditions, and therefore financial needs, differ from country to country Financial organizations, which are conditioned by the general economic structure of the country concerned, must also vary from one country to another. For another, the grouping and content of financial institutions within the same country is undergoing rapid changes from time to time. There is often an extension in the range of activities of financial organizations. Thus large banks today may sometimes be appropriately described as 'department stores of finance' inasmuch as they engage in different combinations or classes of banking business. If, therefore, a simple classification of banking institutions according to function is attempted, it should be borne in mind that it may not strictly conform to realities. In actual practice, a bank may engage in one or more of these functions. Nevertheless, a functional classification of banking organizations will help an understanding of their nature. Moreover, what is being attempted is a grouping based on function, rather than on structure; that is, what is done rather than who does it.

COMMERCIAL AND INVESTMENT OR INDUSTRIAL BANKING

The main purpose of a financial system is to accumulate and utilize to the best advantage the community's savings.

On the one hand, it is a mechanism for the pooling of the savings of the community. On the other, it is a mechanism for supplying the financial needs of modern business. These needs may be for a shorter or a longer period. Corresponding to this distinction in time in regard to capital requirement of modern business arises the most important division of banking institutions into commercial and investment or industrial banks to provide for the short-period and long-period financial needs respectively of modern business.

Both commercial and investment banks play a distinctive role in the productive process. By supplying capital for short-periods, commercial banks bridge the gap in time that often exists between the production of finished goods and the payment of their purchase price. Investment banking, on the other hand, is concerned with the provision of the relatively permanent funds of business undertakings. They are thus in a position to influence the directions in which new capital should be applied.

It is interesting to observe that, although commercial banks are a permanent and universal feature of the financial system in every country, separate investment or industrial banks do not exist in all countries. Great Britain, for example, possesses no investment banks worth the name. Long-term capital needs of industries are raised largely by public subscription or are supplied by other institutions such as issue houses or finance companies. Japan, however, established in 1902 a special institution for the financing of industries entitled the Industrial Bank of Japan. Certain countries, again, have a system of what is known as mixed banking: that is, the commercial banks also fulfil industrial banking functions. Such a practice obtains in Germany, Austria, Switzerland and Italy. In these countries, commercial banks also undertake industrial financing.

Co-operative and Land-mortgage Banks

Commercial and investment or industrial banks generally supply the financial needs of industries. Their functions are fulfilled in the sphere of agriculture by co-operative and land-mortgage banks respectively. In some countries, however, commercial banks supply the short-term financial needs of agriculturists as, for example, in the U. S. A., Canada, Ireland and other countries. At the same time, specialized institutions called co-operative banks have grown up in these and other countries to provide for the short-term financial requirements of agriculturists to enable them to tide over the period intervening between the sowing of crops and the receipt of their sale price. Capital required for permanent investment such as for the purchase of land, cattle or agricultural machinery is furnished by land-mortgage or farm-mortgage banks.

Central Banking

Practically all countries in the world today have an institution to which the term 'central bank' may properly be applied. In its organization and working, a central bank, like a commercial bank, may vary from one country to another. But the term is used to designate any central institution which holds the ultimate banking reserves of a country and which, in addition, formulates its policies with a view to attaining the maximum benefit from the credit structure for society as a whole, rather than with a view to profit for its stockholders. In pursuance of this objective, a central bank will have to control commercial banks so as to promote the general monetary policy of the state. Another fact which distinguishes a central from a commercial bank is that the former does not, as the latter does, exist to make the maximum of profits for its shareholders. To a

central bank, the maintenance of the general economic stability of the country rather than profits is the prime consideration.

SAVINGS BANKING

By savings banking, as distinguished from commercial banking, is meant the deposit of funds not subject to withdrawal on demand, but ordinarily payable on notice of shorter or longer duration. As savings banks are considered to attract the savings of small savers in particular, special restrictions exist in most countries for the control of their business. Practically all countries possess postal savings banks, whose working is subject to some form or other of government control. Other types of savings banks exist in some countries. America, for example, had what are known as the mutual savings banks, which are quasi-mutual institutions and non-profit making in character. In Canada, apart from postal savings banks, there are Dominion Government savings banks, Provincial Government savings offices and Quebec savings banks.

The distinction between savings and commercial banks has been largely blurred today. This is due to the fact that commercial banks have been increasingly attracting savings deposits. They had naturally looked on with envy in the past upon the large funds disposed of by savings banks, and desired to obtain a share of this business. They have generally succeeded in their object by accepting what are called 'fixed deposits' in Great Britain and 'time deposits' in America. These deposits are often withdrawable, not on demand, but on notice of longer or shorter duration; but in some cases, they are also withdrawable by means of cheque. When this is so, the distinction between savings and commercial banking practically disappears.

TYPES OF BANKS IN INDIA

In India, there exist all the different classes of banks described above. At the apex of the banking structure is the Reserve Bank of India, which is a Central Bank. The Reserve Bank was inaugurated in 1935. Before that time, there was in India no central banking institution, as the term is usually understood. The Imperial Bank of India which was constituted by an Act of the Indian Legislature, was essentially a commercial bank, although it functioned as a central bank of a sort. Under the head of commercial banks are to be included today the Imperial Bank of India and the numerous joint-stock Indian commercial banks. There is in Indian money market another special type of bank, which is essentially commercial, but is known as the exchange bank. The exchange banks are so called because they specialize in foreign exchange business. They are all foreign banks, and their main business is, or at least was confined to the financing of the foreign trade of this country. In recent times, however, there has been some change in the business done by the exchange banks. Although they are still mainly concerned with financing the import and export trade of the country, they have also been extending their inland business. At the same time, the Indian commercial banks, which previously took absolutely no part in the foreign exchange business, have recently been developing, although to a negligible extent, this side of their business. The old exclusiveness of the exchange banks as a specialized type of institution has therefore been partially obliterated.

The Indian commercial banks including the exchange banks cater only to the short-period financial requirements of trade and industry. There are, however, no specialized institutions for supplying the long-term needs of Indian

industry. Long-term capital has to be raised either by public subscription or it is furnished by managing agents or capitalists themselves. Properly organized industrial or investment banks do not exist in this country. In Bengal an institution entitled 'The industrial Credit Syndicate' was established in March, 1937, to provide the long-term capital requirement of small and medium-sized industries. Unfortunately, this institution has not proved a success.

In the sphere of agriculture, money-lenders and co-operative credit societies provide the short-term and intermediate credit needs of the ryot, while the long-term finance he needs is supplied by land-mortgage banks.

CHAPTER III

FUNCTIONS AND SERVICES OF A BANK

To describe the functions and services of a bank is to define what it is. A general definition of a bank or banking is by no means easy, for the theory and practice of banking have varied from age to age, and still vary from country to country. We shall not at this stage enter into a critical examination of the legal definition of a bank. It will suffice for our purpose here to say that a bank i.e., a commercial bank, is a corporation which accepts deposits from the public repayable on demand by cheque.

Main Banking Functions

The primary function of banking is to receive money from the public withdrawable on demand by the depositor. This corresponds to the usual arrangement under which *current accounts* are opened and conducted. But, in addition to receiving money on current accounts, a bank also accepts money on what are known as *deposit accounts*, under which the depositor is allowed to withdraw money on the expiration of an agreed period of notice. With English banks, the customary period of such notice is seven days, although large sums are also accepted by them on *fixed deposit* for definite periods of, say, one, two, three or six months, the right of withdrawal accruing to the customer automatically on the expiry of the agreed period of the deposit. Arising out of the function of accepting deposits from the public is that of making advances to trustworthy borrowers for legitimate purposes. These advances may take two principal forms. In the first place,

they may be made either by granting a loan of a fixed amount or an overdraft on a current account up to a certain maximum figure. In the second place, they may be allowed by discounting bills of exchange and promissory notes. In discounting bills and promissory notes, what the banker does is to buy from the holder of the instrument the right to receive the payment of the debt as expressed on the instrument at its maturity This he does by giving the holder of the instrument its present value, that is, the holder receives from the bank the amount promised in the instrument, less the interest on that amount at an agreed rate for the time which the bill or note has still to run.

Formerly, there was yet another important function of a bank, namely, that of issuing notes. The issue of bank notes by a private commercial bank was a very profitable business inasmuch as it could meet the demands of depositors by the payment of such notes, that is, its mere promises to pay, while still retaining the money in which the deposit was originally made for the purpose of its business. The ability to issue notes was, of course, conditioned by the credit of the bank among the general public ; for, only if the public had sufficient confidence in the stability and soundness of the bank would it be willing to accept the bank's notes for settling mutual indebtednesses. It was found out in course of time, however, that the temptation to over-issue was so great that many banks had come to grief with disastrous consequences to their depositors. In fact, many of the currency troubles which England experienced during the nineteenth century were due to this cause. The English Bank Charter Act of 1844 restricted the right of note-issue by private banks, and also made provision for its gradual extinction. Today, the right of note-issue has been taken away from the commercial banks

and is vested in central banks in practically all countries of the world. In India, it is the Reserve Bank of India, our Central Bank, which enjoys the sole power of issuing notes. Prior to the establishment of the Reserve Bank of India in 1934, the right of note-issue was exercised by the Government of India.

Thus, of the three main functions of a bank, namely, deposit, discount and issue, the last one has become extinct. Deposit and discount, under which is also included loan, are today the principal functions of a commercial bank. They correspond to the dual role of a banker, namely, that of borrowing with one hand and lending with the other.

SUPPLEMENTARY BANKING FUNCTIONS

Apart from the primary function of linking up the lender and borrower of liquid capital, a modern bank performs many other functions of considerable significance and utility to its customers and to the community generally. These functions were originally undertaken in most cases by the banker for the convenience of his clientele, but have in turn led to the profit and advantage of the banker himself. Some of these functions arise out of, while others are extraneous to the ordinary business of a bank. These supplementary functions may conveniently be grouped under two broad heads, namely,

(1) Agency services, and (2) General Utility services.

AGENCY SERVICES

The services which a bank renders as an agent are mainly as follows:

(a) Collection and payment of cheques, bills and promissory notes.

(*b*) Execution of standing orders. A customer may leave standing instructions with his banker for the payment of sums to various persons or institutions by debit to his account. Such orders are usually given in respect of payment of insurance premiums, subscriptions to clubs and societies, and similar payments of a regularly recurring nature. The bank may charge a small commission for the rendering of such services.

(*c*) Collection of dividends or interest on stocks and shares. The customer may instruct the issuer of securities that he may hold to pay the interest or dividend that may be declared on them to his own bank. He will thus avoid the trouble of endorsing and paying in such dividend warrants. The banker usually levies a very small charge for the collection of dividend and interest on behalf of his customer.

(*d*) Purchase and sale of securities. Although it is not the usual practice for a bank to advise its customer regarding investments, it will furnish him with such particulars as may be obtained from a recognized stock-broker. It will, however, undertake to purchase or sell stocks or shares on behalf of its customers It does not levy any charge on the customer for this service, but shares with the stock-broker the commission the latter is entitled to receive.

(*e*) Transfer of funds from one bank or branch to another. By arrangement, a customer can also draw cheques on a particular office of a

bank and have them cashed at other offices or agencies.

(*f*) Acting as trustee or executor. The administration of a will or of a settlement requires specialized knowledge and a modern bank is willing, for a small fee, to undertake such complicated duties on behalf of such of its customers as may desire to nominate it in such capacities.

(*g*) Acting as agent, correspondent or representative of his customers, and of other banks and financial houses at home or abroad.

General Utility Services

A modern bank performs many general utility or miscellaneous services. Of these, the important ones are :

(*a*) The issue of personal and commercial letters of credit. These enable the customer to profit by the superior credit of the bank. Thus, money can be promptly paid out to a customer or to his agent, and bills drawn by his creditor can be accepted by the bank or any of its branches, agencies or correspondents.

(*b*) The transaction of foreign exchange business. This provides the commercial community with facilities for its dealings with foreign nationals, and is also a profitable business to the banker. In assisting foreign trade by discounting foreign bills of exchange, a bank has sometimes to arrange for the transport, insurance and warehousing of goods. A freight and insurance department is a common feature of many commercial banks. In most foreign countries, the business of foreign

exchange is handled by ordinary commercial banks. In India, however, there is a group of specialized institutions known as exchange banks which handle the business of foreign exchange.

(*c*) Acceptance of bills of exchange on behalf of customers. This is another means whereby the banker lends his name to others for a small commission, and thus enables the customer to profit by the bank's superior credit. Thus, where a customer has a creditor willing to offer him credit but not possessing sufficient knowledge of his credit-worthiness, the bank, which should know, accepts the bill on behalf of his customer and thus enables him to obtain the desired credit.

(*d*) The safe custody of valuables and securities. A bank undertakes the safe custody of valuables and important documents against theft and fire They are kept in specially constructed strong rooms, and the bank acts as a bailee of the goods entrusted to its keeping.

(*e*) Acting as a referee as to the respectability and financial standing of his customers. This is a very valuable service to businessmen for it enables them to obtain reliable and speedy information about the general standing of people with whom they have business transactions with a view to avoid incurring any loss through giving credit to persons of little or no financial worth. This information should be collected by a banker with great care, and is supplied in utmost secrecy.

(*f*) Supplying trade information and statistics. Many of the big banks in advanced countries possess a separate information and statistical department. This department collects trade and business information and statistics from the bank's various branches and agencies, both at home and abroad. Such information is placed at the disposal of its customers. Sometimes the bank publishes a monthly review which contains economic and financial information and statistics of great utility to the commercial community.

It will thus be seen that a bank renders many valuable services to the public as well as to the trade and industry of a country. Its most important service is that it pools together the scattered savings of a community and makes them available to those who need funds for productive purposes. The ease with which money can be obtained from banks by businessmen acts as a stimulus to productive enterprise. They are also benefited by the advice and information which banks are always ready to place at their disposal. By the choice they exercise as to the persons who will be offered financial assistance and accommodation, banks are in a position to influence the directions into which the capital of a country will flow. Further, it has been aptly said that the existence of a sound and competitive banking system is in itself an encouragement to saving, thrift and economy for even the small investor is made to appreciate the facilities of safe investment which a bank provides, and is thus imbued with a feeling of security.

In Gilbart's words[1], bankers act as 'public conservators

[1] *The History, Principles and Practice of Banking*, Vol. 1 pp.226-7.

of the commercial virtues'. In their own interest 'they encourage the industrious, the prudent, the punctual and the honest—while they discountenance the spendthrift and the gambler, the liar and the knave. They hold out inducements to uprightness, which are not disregarded by even the most abandoned. There is many a man who would be deterred from dishonesty by the frown of a banker, though he might care but little for the admonitions of a bishop'. It is therefore no exaggeration to say that a country having a sound and efficient banking system is possessed of one of the essential foundations of prosperity.

CHAPTER IV

THE BANK STATEMENT

A BANK statement is a balance-sheet that depicts the condition of the particular bank at a given moment. It portrays the results of the bank's operations at that time. The balance-sheet may also be regarded as indicating the ways in which the bank raises its funds and the ways in which it uses them.

Unfortunately, there is no common form for the presentation of a bank's statement. In England, the larger joint-stock banks have virtually agreed upon some form for their statements. In America, the fact that law enjoins banks to submit regular reports in respect of certain items has imparted some amount of uniformity to their periodical statements. In India, the information that is revealed in the balance-sheets of banks is presented in diverse forms, and consequently a helpful comparative study is rendered very difficult. Yet, the nature of banking business is such that it is possible to draw up some form of a common balance-sheet for all banks, although the items mentioned may not be of a nature as to offer detailed information about the operations of individual banks.

A Common balance-sheet will contain the following main items:—

LIABILITIES	ASSETS
CAPITAL	Cash and balances with other banks
Authorized ...	including the Reserve Bank ...
Subscribed ...	Money at call and short notice ...
Paid-up	Bills discounted and purchased ...
Reserve fund ...	Investments ... .
Current, deposit and	
other accounts ...	Loans and advances to customers ..
Liabilities for accept-	Liabilities of customers for accept-
ances, endorsements,	ances, endorsements, etc ...
etc.	Bank premises and other fixed accounts ...

In examining this balance-sheet, we shall begin with the left hand or liabilities side. This side represents the sources from which the banker derives his funds for employment in his business as lender of capital.

Capital.—The authorized capital is the maximum amount which the bank is permitted to issue under its Memorandum of Association The subscribed capital is what has actually been issued and subscribed for. The difference between the authorized and the subscribed capital is the margin which the banker could obtain by issuing the balance of his authorized capital. Paid-up capital represents the amount invested in the bank by its shareholders. It is the actual cash capital of the bank. It is the general practice for banks to issue shares of which only a portion of the nominal amount of each share is paid in cash. The balance not called up per share or the 'uncalled liability' on each share continues to be a liability on each shareholder and is an additional margin of safety for depositors and creditors of banks. There is no uniform practice among banks with regard to the proportion of their unpaid capital to the amount paid up. Many banks in this country have called up only fifty per cent of the nominal value of their share capital. Although the balance of fifty per cent is a reserve liability of shareholders, it is generally known that no big or established bank calls up its unpaid capital, so that its magnitude has ceased to exert any appreciable influence on the credit of the bank. Many English banks hold some part of their unpaid capital in the form of 'Reserve Capital', which may be called up by the directors only in the event of the liquidation of the bank.

Reserve Fund.—The Resrve Fund is an accumulation in the hands of a bank of sums allocated from its profits over

a period of years It is usually invested in first class securities. The Reserve Fund should be distinguished from the uncalled or reserve liability on subscribed capital, or from 'Reserve Capital' as explained above. The Reserve Fund is not subscribed by the shareholders, but is built up from profits. The paid-up capital and the reserve fund constitute the working capital of a bank. In the event of heavy losses, a bank may draw upon its Reserve Fund. The Fund thus operates as an additional safeguard for the bank's customers, but it belongs to the shareholders and may be utilized to issue to them shares on bonus terms or to equalize dividends from year to year.

In addition to the published Reserve Fund, many banks provide out of profits 'secret reserves' which are not shown in the balance-sheet. Such secret reserves lend additional safety to the bank's position. They are generally hidden by the undervaluation of assets. For example, the appreciation in the value of the bank's securities may not be taken account of, or premises may be given a value in the balance-sheet much below their market price. These reserves may be utilized, if necessary, for meeting exceptional losses as in times of acute economic depression.

Current, Deposit and other Accounts.—These items represent the liabilities of the bank to its depositors. They are the largest single item on the liabilities side. It is in effect the bank's business so to invest these amounts as will enable it to earn a fair dividend for its shareholders without in any way endangering the safety of the money entrusted to it by its depositors.

The bank receives money on current or deposit accounts. Money deposited in current accounts is withdrawable on demand, while money left in deposit accounts is withdrawable after the expiry of a fixed period or certain agreed

period of notice. The latter corresponds to the 'fixed deposit' accounts of Indian banks. In addition, our banks receive money in savings accounts. The sums are either returnable after an agreed notice, or withdrawable by cheque only once or twice a week, and sometimes a maximum figure up to which sums are withdrawable at a time is fixed. The ratio between the money left on current and on deposit accounts shows considerable variation from time to time. In times of depression, the ratio of deposit accounts to current accounts generally rises, while the reverse is true during periods of prosperity.

The item 'other accounts' includes credit balances in the bank's ledgers, such as balances standing to the credit of Unclaimed Dividend or Unclaimed Interest Account.

Liabilities for Acceptances, Endorsements, etc.—This item represents the liabilities of the bank in respect of bills of exchange it has accepted or endorsed for the accommodation of its customers. It also includes the bank's contingent liability in respect of confirmed credits, forward exchange contracts, guarantees and other engagements entered into by the bank on behalf of its customers All these obligations the bank has to honour, even though its customers should fail to recompense the bank for such payments The customers are, however, liable to recoup the bank for such payments made or loss incurred therewith, and the total amount is 'offset' by a corresponding item on the other side of the balance-sheet.

ASSETS OF A BANK

The right hand side of the balance-sheet gives a picture of how money that is entrusted to a bank by its depositors and shareholders is employed. Successful banking depends upon the ability of the management to distribute judiciously

its funds among the various kinds of investments known as assets. A broad division of assets may be made into two principal categories, namely, (*i*) liquid assets such as cash or other assets easily and readily convertible into cash, and (*ii*) comparatively less liquid assets such as investments in first class securities and in loans and advances to customers.

The assets of a bank are usually arranged in a balance-sheet in order of liquidity, the most liquid assets appearing first. Thus, the item 'cash', which is most liquid, comes first, while the item 'fixed and permanent fixtures' which are least easily convertible into cash, appears last in a balance-sheet.

The items on the assets side beginning from 'Cash and balances with other banks and Reserve Bank', to 'Loans and advances to customers' will be explained fully in a subsequent chapter. At this stage, therefore, we need not dilate on these items.

The item 'Liabilities of Customers for Acceptances, Endorsements, etc.' is a contra entry to the similar item on the liabilities side. It represents the total dues of the bank's customers in respect of obligations which the bank has accepted on their behalf These two items on the assets and liabilities sides therefore cancel each other.

Bank premises and other permanent fixtures represent the fixed investments or the least liquid assets of the bank. They cannot be easily realized in case of emergency. It is, however, the practice of banks to allow for annual depreciation in respect of the value of these items so that, in actual fact, the real value of land, buildings and other permanent fixtures owned by a bank far exceeds their book value.

Analysis of the Bank Statement

In examining the balance-sheet of a bank, the main points that need be considered are its profitability, safety and the nature of its business. Thus, according to Steiner,[1] this analysis considers the following leading features:

A. Profitableness as indicated by:
   (a) Earnings as shown by dividend record and growth of surplus and undivided profits.
   (b) Deposits in relation to stockholders' investments.

B. Safety and liquidity, as indicated by:
   (a) Deposits in relation to stockholders' investments. To the latter some add reserves.
   (b) Loans and investments in relation to deposits.
   (c) Reserve position.

C. Nature of business, as indicated by:
   (a) Loans in relation to deposits.
   (b) Investments in relation to deposits.
   (c) All other loans in relation to total loans and investments.

No hard and fast rules in regard to these criteria may be laid down for all banks. In judging an individual bank, what should be considered is how its position with regard to the criteria mentioned above compares with that of the aggregate position of all banks or of the best banks in the locality. Another criterion which should also be considered is the average rate of interest paid on deposits, which is indicated by the relation of the amount paid out as interest to the total deposits of the bank. The lower this rate is, the better the bank. Again, the lower the average rate of interest earned on its invested funds, the better the bank; for it is an indication of the better quality of its assets from the standpoint of safety and liquidity.

[1] *Money and Banking*, p. 260.

CHAPTER V

INVESTMENT POLICY

BEFORE we examine and elucidate the assets side of a bank's statement, item by item, a few words may be said by way of explaining the general investment policy of a commercial bank. It is universally recognized that the most important problem in banking administration is that of investing its deposits and paid-up capital in various forms of earning assets This is also known as the portfolio policy ; the bank's portfolio being nothing but an arranged and digested scheme of its assets.

ELEMENTS IN INVESTMENT POLICY

There is no universal investment policy applicable to banks. The local situation or the conditions in which a bank has to operate, must necessarily have an important bearing upon a bank's portfolio policy. Thus, the nature and availability of deposits as well as of assets differ not only from country to country, but also from region to region within the same country. Conditions in India, for example, largely differ from those in England. Neither the cheque habit nor the commercial bill habit is so prevalent in India as in England. Within a country again, banks in rural areas face a problem materially different from that faced by banks in urban and industrial areas. In rural areas, demand for loans is usually less liquid and less diversified as the main occupation of the people is agriculture. All these differences naturally have their influence on portfolio policy.

Apart from such limitations as local conditions impose, a bank has some discretion in choosing its assets. Its guid-

ing considerations are, however, yield, safety and liquidity. In the first place, as a business institution, a commercial banks aims at securing maximum profits. In this, it differs from a central bank, which even though privately owned, seeks to serve broad national interests. In the second place, since the bank's funds belong mainly to depositors, it cannot afford to lose them by assuming large or unnecessary risks in its investment policy. In the third place, since most bank deposits are withdrawable on demand, it must maintain a sufficient degree of liquidity in its assets. Such assets may be cash, or other readily realizable assets.

From the point of view of banking business, these three attributes have a close inter-relation. It has been stated that as a business, the primary object of banking is to earn as much profit as possible for its shareholders. Since, however, profits are earned on assets which are obtained by exchanging funds left with a bank by its depositors, it is essential that a bank must enjoy their fullest confidence. This confidence is dependent upon the ability of a bank to meet readily the demands for cash made upon it by its customers. This ability to offer cash in exchange for bank deposits is referred to by bankers as liquidity.

The concept of liquidity has a twofold significance. On the one hand, in means a quality in the assets which enables them to be readily realized in cash. This amounts to saying that they are easily saleable or readily shiftable to other persons or institutions. On the other hand, liquidity also signifies that these assets should be convertible without any loss. Thus, shiftability and absence of risk of loss are the two essential elements in the concept of liquidity. Its meaning can be further clarified by an illustration. Thus long-term government securities have a ready market. They can be sold easily in the stock market. They the therefore easily

shiftable. But there is no certainty that they will fetch when they are sold the price at which they were bought. The sale price may be higher or lower than the purchase price. If it is lower, the bank will suffer a loss, and if higher, it will earn a profit on its capital investment. Thus, assets in the shape of government securities, although perfectly shiftable, are not without risk of loss, unless, of course, the banker can wait till the maturity date of the securities when the government will redeem them at their face value. Thus, government securities cannot be regarded as the ideal form of liquid asset. In fact, the only ideally liquid asset is cash. An example of an asset which is without any risk of loss but not readily shiftable is a loan offered against the personal security of a borrower. Here, if the borrower be absolutely honest, dependable and wealthy, and if further, the risk of his premature death be covered by having an insurance policy on his life assigned to the banker, the asset will be absolutely safe. But it will not be something which can be easily sold in the market. In other words, it will not be readily shiftable.

The idea of shiftability may be examined a little further. In normal times, certain types of assets can be easily sold in the market. They are highly shiftable. But in abnormal times, for example, during a period of acute economic depression or if there should be a general run on all banks, even such assets may not be easily sold. Further, should such assets of all banks be simultaneously released in the market, their value would slump heavily. In crises like these, the central bank of the country comes to the rescue. It provides funds for the commercial banks against securities acceptable to it and thus helps to allay panic and restore normal conditions. But the central bank will lend against or discount only certain defined classes of assets known as

eligible paper. As the central bank is the lender of the last resort, its eligibility rules must have an important bearing on the concept of shiftability of a commercial bank's assets. 'The eligibility canons (the rules by which the acceptability of assets is determined) of the central banks are therefore of vital importance to the liquidity of the commercial banking system'[1].

In choosing its assets a bank, as already explained, is guided by considerations of profit, safety and liquidity. Of these, safety and liquidity are more important than yield. It has been aptly said that more danger exists to a bank from striving after profits than from striving after safety. Only when safety and liquidity have been adequately ensured can yield be considered.

Sections of the Portfolio

A bank's funds are distributed among a variety of assets beginning from the most liquid, cash, down to the least liquid, bank premises and other permanent assets. We may arrange these assets into the following important classes:

(*a*) Primary reserve. This includes cash in vault, balances with other banks including the central bank, and items in process of clearing or collection.

(*b*) Secondary reserve. This includes money at call and short notice, and bills discounted or purchased.

(*c*) Investments.

(*d*) Loans and advances. These may be or may not be secured by collaterals.

(*e*) Facilitating or incidental assets. These include

[1] Sayers op. cit., p. 216.

the bank's building and furniture and fixtures, and other real estate.

(*f*) Contra items, offsetting corresponding liabilities.

We shall examine the first four items in the following chapter. Items (*e*) and (*f*) have already been explained in the last chapter.

Banking Technique

Since the principal business of banking is associated with the granting of credit, banking technique should be considered in relation to the provision of credit and the handling of items arising out of credit transactions. Its principal aim should be to collect information about the financial standing and business acumen and integrity of likely borrowers so as to safeguard the bank against losses in its business of extending credit, for, to offer loans and advances without proper investigation would be to invite possible losses. The main function of credit analysis is to reduce all credit risks to a minimum.

It is a commonplace assertion that a bank must ensure safety in its investment policy. Yet probably no investment is completely devoid of all risk of loss. It is true that secured investments are, as a rule, much safer than unsecured ones. But even the safety of secured investments is sometimes dependent upon the integrity of the borrower. Further, the unsecured assets of a bank are not inconsiderable, and in these cases credit analysis is of paramount importance. In some countries, unsecured loans and advances are even preferred, for example, in the U. S. A., inasmuch as they are generally required to finance current commercial transactions and are therefore more liquid and suitable for commercial banks. It may be noted that in the U. S. A., about fifty per cent of the

loans made by commercial banks is unsecured. In that country, a department for credit analysis and investigation is an essential adjunct of every good commercial bank.

Sources of Credit Information

A commercial bank, like any other commercial or financial institution, can utilize various sources of credit information. These sources may be classified according to the method of obtaining them as (*a*) internal and (*b*) external.[1]

The internal sources are :—

(*i*) the customers' financial statement ;

(*ii*) in the case of old customers, the past history of the borrower as revealed by the bank's records ;

(*iii*) personal calls by the bank's representative upon the borrower in order to inspect his place of business ;

(*iv*) interviews and direct correspondence with the borrower.

The external sources are .—

(*i*) other banks ;

(*ii*) firms with which the borrower has been or is doing business ;

(*iii*) mercantile agencies—both general and special agencies ;

(*iv*) credit exchange bureaux ;

(*v*) court records, newspapers and printed reports.

Of all these sources, internal and external, the most important is the borrower's financial statement. Financial statements should comprise both the balance-sheet, and the profit loss account duly certified by a registered accountant.

[1] See *Contemporary Banking* by Willis, Robey & Chapman, Ch. XXII.

Whenever possible, financial statements over a number of years should be obtained for this will enable the banker to judge better the progress made by the business in question. The past record of a borrower, if he is not new, will also yield valuable information for the assessment of the integrity, creditworthiness and the nature of business of the borrower.

Of the external sources, the most important are the first two. Credit information is exchanged by banks among themselves in strict confidence. This procedure substantially reduces the cost of this work and also enables a bank to find out if a customer has been borrowing from more than one bank. The services of mercantile agencies can also be utilized for supplementing the information collected by a bank from other sources. There are two classes of mercantile agencies in the U. S. A. There are, in the first place, general agencies, for example, Dun and Bradstreet, which offer information of a general nature. Secondly, there are special agencies like Bishop and Proudfoot, which devote special attention to the past records of officers and directors of the concerns under investigation. In addition, there are a few agencies specializing in particular industries, such as the Lumberman's Credit Association or Wood's Dry Goods Commercial Agency. No such mercantile agencies, however, exist in India.

CHAPTER VI

BANK ASSETS

CASH

CASH is the completely liquid form of asset and is held in hand by banks to meet the demands of their customers. Originally, it meant that which was *encaissé*, that is, put into a chest or till. Today it includes currency held in the till of a bank plus its deposits at other banks, including the central bank. In recent years, British joint-stock banks have no longer shown balances with other banks, excluding, of course, balances with the Bank of England, under the heading 'Cash'. What is usually included under cash in the balance-sheets of our commercial banks has been split up under two heads in the balance-sheets of British joint-stock banks, namely, (*a*) coin, notes and balances with the Bank of England ; (*b*) balances with, and cheques in course of collection on other banks in the U.K., Ireland and other countries. In the U. S. A , the item cash in the balance-sheets of commercial banks is usually split up under the following heads : (*a*) gold, silver and small coins ; (*b*) inland notes and balances with the Central Bank ; and (*c*) other items of a cash nature.

FACTORS GOVERNING CASH HOLDING

Cash is an asset which yields no return. As a commercial bank aims at increasing its profits as much as possible it is but natural that it would like to hold as many earning assets as possible, and reduce its cash holding to a minimum Some amount of cash it has to hold in order to be able to carry on its business. In the first place, it requires

cash to meet the daily demands for withdrawal of deposits in lawful money. In the second place, settlements with other banks for any negative balance at the clearing house have to be made in cash, and here cash includes balances with the central bank. In the third place, a bank should also be in a position to meet unusual demands for withdrawal of deposits. Heavy demands for withdrawal of deposits can sometimes be reasonably forecast, for example, before bank holidays. A bank should have sufficient cash holding either in its vaults or with other banks to meet such unusual demands. Should, however, demands for withdrawal of deposits result from causes which cannot be reasonably forecast, a bank falls back upon what is called its secondary reserve for replenishment of its cash.

Some other factors which also have their bearing on the amount of cash a bank considers it necessary to hold may be mentioned. Firstly, it is affected by the habits of the bank's clientele as also by the economic condition of the locality. Thus, in a community where exchanges are numerous, a larger cash holding may be necessary than in a society where monetary transactions are less frequent. In the second place, the question whether the cheque habit is prevalent or not has a very important bearing on the magnitude of the cash holding. It should be evident that in a society where the banking habit is well-developed and payment by cheque prevalent, a bank will have to hold much less cash than in a community where these practices are ill-developed. Thirdly, the existence of a clearing house diminishes the amount of cash that need otherwise have to be held by a bank for in the clearing house a large number of cheques received by various banks drawn upon one another will be set off against each other, and only balances outstanding will have to be paid, not necessarily

in legal tender cash, but usually by cheques drawn upon their balances with the central bank. Fourthly, a bank with a small number of depositors with large balances will have to maintain a larger cash balance than one with numerous depositors with small accounts, for if there are only a few depositors, and especially if they belong to the same business, the bank may have to meet heavy demands for withdrawal at particular seasons. Fifthly, the amount of cash held by other banks in a locality influences the cash holding of any other bank operating in the same place. It is popularly believed that the higher the ratio of cash to deposits, the sounder the bank. If a bank in any place maintains a high cash reserve, other banks in the same locality also increase their cash balances with a view not to suffer in prestige or popularity. It may incidentally be mentioned that a high cash reserve is by itself no criterion of the soundness of a bank. The safety of a bank depends upon the soundness of its investments as a whole. Sixthly, the cash holding of a bank is also influenced by the nature of its other investments. If a bank holds a considerable proportion of its deposits in easily realizable assets, such as bills, its cash requirements will be less than if its other assets are comparatively less liquid. Thus, a comparatively higher cash holding may be an indication of a less liquid position in respect of other investments.

The Cash or Reserve Ratio

The proportion of cash, including balances with other banks, to deposits that a bank holds is called the cash or reserve ratio. The proportion of deposits to cash or reserves may be called the deposit multiple. Thus the cash ratio and the deposit multiple are reciprocals of each other.

The usual cash ratio of commercial banks varies in

different countries. It is lowest in Britain and the U.S A. In Britain, it varies between 9 and 10 per cent, and the figure for the U. S. A. is about the same. In India and France, it is usually between 10 and 20 per cent. The comparatively much lower cash ratio in Britain or the U. S. A. is due to a very much wider use of the cheque system in those countries than in France or India.

In some countries, commercial banks are obliged by law to maintain with the central bank a certain small percentage of their deposits as reserve. This is known as the legal or statutory reserve. Thus, in the U. S. A., different types of member banks of the Federal Reserve System are required to keep 7, 10 or 13 per cent of their demand deposits with the Federal Reserve Banks of their district. In India, scheduled banks have to maintain a reserve equivalent to 2 and 5 per cent of their demand and time deposits respectively with the Reserve Bank. In countries where the law provides for the maintenance of a statutory deposit with the central bank, commercial banks usually hold a cash balance much higher than what is provided for in the statute.

Money at Call and Short Notice

After cash, funds lent to the money market are regarded as the most liquid form of asset. They have an advantage over cash in that they earn some interest. Loans to the money market may be grouped in three broad categories, namely, 1. loans to the bill-market consisting of discount houses and bill-brokers, 2. loans to stock-brokers and 3. loans between banks themselves. In London, money at call and short notice is lent mainly to discount houses and bill-brokers and only partly to stock-brokers. British banks also lend for longer periods to stock-brokers, but these

loans are shown in their advances Money lent at call and short notice is repayable either on demand or at a week or two's notice. The rate of interest earned is between ½ and 1 per cent, and its amount is usually about 7 per cent of the bank's deposits. This item plays a significant role in the working of the London money market which we shall examine in its proper place.

In New York, which does not possess a discount market comparable to that of London, call loans are usually lent on the Stock Exchange. Call loans in the New York money market usually mean loans repayable on the demand of the lender without previous notice and secured by the pledge of investment securities, that is, stocks and bonds which are usually dealt in on the New York Stock Exchange. The call rate is, of course, determined by the demand and supply of funds for this purpose It is usually above the rediscount rate of the Federal Reserve Bank. In London, it is much below the Bank rate and is almost equal to the London Bank's deposit rate. In New York, if a call loan is not repaid on the following day, the rate applicable thereafter may change from day to day. This future rate is known as the 'renewal' rate. In New York, the renewal rate is fixed by a committee of the Stock Exchange in consultation with leading bankers.

In India, there is no discount market. Further, loans to the Stock Exchanges are not in the nature of call loans and they appear therefore under the heading of loans and advances. Call loans in India usually refer to funds lent by banks to one another. The call money market, which is confined mostly to dealings between banks, is more active in Bombay than in Calcutta. Inter-bank call money is generally arranged through brokers, although banks in need of temporary funds may also approach other banks

directly.' The rate of inter-bank call money varies with the state of the market. It is usually higher in the busy season than in the slack season. There is a tendency for the rate to decline from May or June and then to rise again from November or December. The actual rate varies between ¼ per cent and 1 per cent according to the period of the year and the demand for call funds in the market.

Bills Discounted and Bought

Bills discounted may be promissory notes, bills of exchange or Treasury Bills In England, promissory notes are rare. Bills discounted by British banks consist of international trade bills, Treasury Bills and a small volume of inland bills. Sometimes a bill bears in addition to the names of the firms concerned, the name of a well-known bank or of an accepting house. Such a bill is known as a bank bill while other bills are known as trade bills. The special characteristic of a bank bill is that the bank also guarantees that the bill will be paid on the due date. In England, Treasury Bills yield about ½ per cent, bank bills about the same or a little more, and trade bills between 2 to 2½ per cent. Bills usually amount to from 12 to 20 per cent of deposits. Bils discounted, money at call and short notice and cash constitute the liquid assets of a bank. The liquidity standard of British commercial banks is to maintain a cash ratio of about ten per cent, provided, however, that the total liquid assets inclusive of cash are between 30 and 33⅓ per cent. If the total liquid assets should be lower than this, the cash ratio should be higher, and *vice versa*.

In the U. S. A., although a considerable proportion of the assets of commercial banks consists of promissory notes, with or without security, and trade acceptances, official

statistics make no distinction between loans and discounts. Discounts are shown under 'Loans and Advances'.

In India, the bills portfolio of commercial banks, particularly of Indian banks, is small. There is no bill market in the sense in which a discount market exists in London. The exchange banks carry a large portfolio of foreign bills of exchange. But Indian banks invest but a comparatively small proportion of their deposits in either trade or Treasury Bills.

INVESTMENTS

Investments constitute a banker's fourth line of defence, after cash, money at call and short notice, and bills discounted. They also yield a higher return than can be obtained on these liquid assets, although the return is not as high as it is on loans and advances. When the demand for loans falls off, the banker invests his funds in gilt-edged securities, and when the demand for loans increases, he meets it in all probability by realizing his investments. The investments of British banks are almost entirely in Government securities, with some infusion of other gilt-edged securities. In the past, their investments varied between 14 and 17 per cent of their deposits. Prior to the last war, they stood at about 27 per cent, but declined to about 25 per cent in 1945.

The percentage of investments to deposits is much higher in the U. S. A. than in England. Thus for 1937, 1940 and 1944, it was 44, 40 and 63 respectively.

The investment portfolio of the Indian commercial banks is also considerable. This is largely due to the undeveloped state of a bill or a call-money market in this country. Investment in gilt-edged or semi-gilt-edged securities is therefore regarded as a very liquid type of investment, although, from the standpoint of liquidity, it should be

remembered that these securities are normally highly shiftable but not without risk of loss in respect of capital value. In recent years, the percentage of investment of Indian scheduled banks excluding the Imperial Bank to their deposits has been over 50 per cent. This percentage was 53.7 and 51.4 for the years 1942 and 1943 respectively. For the Imperial Bank of India, the percentage was 71.2 in 1942 and 60.7 in 1943. Most of the securities held are gilt-edged. A small proportion of these securities consists of Improvement Trust, Port Trust or Municipal bonds. Some of the banks have also increased their investments in debentures, shares and stocks of joint-stock companies, but the total of such investments is still very small.

LOANS AND ADVANCES

'In the item "Advances to Customers" ', says Walter Leaf, 'We have reached what is the central portion of the activity of a bank.'[1] Here the banker is brought into direct relation with the public, and it is by the way in which he lends money entrusted to him by the depositors that his capacity and judgement, as well as his usefulness to the community are judged. Loans and advances are the most profitable item in a bank's portfolio. As a bank aims at making the maximum profit, the banker is always anxious to lend as much of his funds as is possible in the shape of loans and advances. At the same time, he has to be careful about the safety of such advances. 'He has to temper liberality with caution. If he is too liberal, he may easily impair his profits by bad debts, and if he is too timid he may fail to obtain an adequate return on the funds which are confided to him for use. It is by his capacity in lending that a bank manager is judged.'[2]

[1] *Banking*, p. 104.
[2] op, cit., p. 155

Loans and advances to customers, although the most profitable items in a bank's assets, are the least liquid. For although an advance or a loan may nominally be repayable on demand, yet it is often difficult to get it repaid at short notice. A trader or business man who has borrowed from a bank to purchase, say, additional stocks, cannot be expected to pay back the debt upon demand. No bank should or can, therefore, rely for funds in an emergency on a wholesale demand upon its customers to repay their loans. On the contrary, if all banks were to do this in a crisis, the probability is that such action would still further aggravate the national financial difficulties and undermine public confidence.

Loans and advances may take various forms and are allowed against varied types of securities. But whatever their form or the security offered, they have a common characteristic in that they must run for a short period. This is a fundamental practice with English banks, which distinguishes them from continental banks, and it is followed by Indian banks as well. In England, the U.S.A. or India, it is recognized that it is none of the business of commercial banks to supply their customers with long-period or fixed capital. Their function is to provide the public with short-period or working capital. In assessing any proposal for an advance or a loan, the banker has to satisfy himself, firstly, as to the period for which the advance is needed, and secondly, the prospects of its repayment on the termination of this period. Liquidity should be his prime consideration, and he should not be tempted by the soundness of the security or the rate of interest offered to impair his judgement about the necessary degree of liquidity in his advances. In addition, a banker wants to be satisfied about the purpose for which

an advance is required, as he usually discriminates against and discourages speculative advances.

Advances of British banks have in the past usually amounted to about 50 per cent of their deposits, but in recent years the percentage has fallen considerably below this. This is due to the lack of a sufficient number of safe borrowers, with the result that the proportion of investments has increased. This is a tendency which is almost a universal one, and applicable to commercial banks in almost all countries. In the U. S. A., the proportion of loans and advances to deposits of commercial banks in recent years has been about 20 per cent. In India, for all scheduled banks excluding the Imperial Bank it was 32 per cent in 1942 and 33.6 per cent in 1943. Ever since the last war, the proportion of loans and advances of commercial banks to their deposits has greatly declined while that of their investments has considerably increased in all countries.

As already stated, loans and advances may assume different forms and may be offered against different types of securities. We shall now explain them by reference to Indian practices.

Forms of Advances

Advances to customers generally assume one of three different forms, namely, loan, cash-credit or overdraft account. The last two are operated through the current account of the customer, while a loan account is treated as a separate one. A loan can be obtained from a bank by a person who has no account with it, although in actual practice a banker will not entertain a proposal for an advance from a person unless he is one of his customers. To operate a cash-credit or an overdraft account, a person must have a current account with a bank.

In their actual operation, an overdraft and a cash-credit account are alike. In both cases, the customer is allowed to overdraw his account with a bank up to an agreed amount. In the case of a loan, a separate loan account is opened and the amount of loan sanctioned to the customer is debited to the loan account and either paid to him in cash or credited to his current account. One great advantage of the cash-credit and overdraft accounts, and incidentally the reason why they are preferred to a loan account, is that while, under these accounts, interest has to be paid only on the amount overdrawn at any time and not on the full amount up to which the customer may have been allowed to overdraw his account, under the loan account, interest has to be paid on the full amount of the loan taken. To safeguard the bank against loss that may ensue by its customer not overdrawing his account at all under arrangements made under the overdraft or cash-credit accounts, although it has to keep funds free for this eventuality in terms of the agreement made with him, an interest clause is sometimes inserted by which the customer is obliged to pay interest to the bank on a certain proportion of the amount arranged for, say one-third or one-fourth, even though he may not have overdrawn his account to this extent.

Another difference between a loan account, on the one hand, and a cash-credit or an overdraft account, on the other, is that the former is generally opened for consumption purposes or for financing the long-period requirements of industries against the security of block capital. Loans are usually of a longer duration than overdraft or cash-credit advances.

Overdrafts are usually granted against the security of stocks and shares, jute and gunny delivery orders, or

bullion. Sometimes advances are granted against the borrower's own promissory note with or without a guarantor, but without any collateral security. Such advances, however, constitute a very small proportion of the total advances granted by scheduled banks. Cash-credit arrangements are usually made against the security of commodities, agricultural or manufactured, stored either in recognized warehouses or mostly, in view of the dearth of good warehouses, in the bank's own godowns.

NATURE OF SECURITIES OFFERED

Advances may be granted against the personal security of the borrower only, that is, against his promissory note. Such advances are known as unsecured advances, but they are not unsecured in the sense that the bank has nothing to fall back upon. The advance is given against the personal credit of the borrower and its security depends upon the present condition and future prospects of the borrower's business. The banker will call for copies of balance-sheets and profit and loss accounts of the business for the past few years, or for as many years as are available, certified by a reliable accountant. He will have to examine these statements carefully with a view to ascertaining the financial condition of the business. In addition he will have to rely upon his knowledge of the personal character of the borrower, his habits, reputation and capacity. All these are sometimes referred to as the three C's, character, capacity and capital.

Where a banker does not consider the personal security of the borrower as adequate, and where, further, the latter is unable to offer any additional collateral security, the banker may ask for a guarantee. A guarantee is an undertaking given to the banker by a person called the guarantor, to be answerable for the debt of another person, namely,

the borrower, to the banker upon the default of the borrower. The advantage of a guarantee is that it is a convenient form of security and can be easily given. Its disadvantages are that it may prove unsatisfactory if the contract of guarantee is not properly drafted, and that, as a security, it is entirely dependent upon the initial and continued solvency of the surety. Before accepting the guarantee of any person, the banker should make enquiries about the character, capacity and financial standing of the guarantor, for what happens in the case of a guarantee is that in addition to the personal security of the borrower, the banker obtains that of the guarantor as well. The banker should also be careful to make clear to the proposed surety the nature of the document he is expected to sign so that he may not afterwards plead that he did not understand its contents. Another point in connexion with a guarantee is that it should be a continuing guarantee, that is, a security which will continue, although the balance of the debtor's account may fluctuate from time to time. A guarantee should therefore expressly state that it 'shall be a continuing guarantee', as otherwise it might be held to cover merely the debt which existed at the time the guarantee was given.

Apart from a personal security or guarantee, tangible securities may also be offered for taking a loan from the bank. Such securities are also referred to as collateral securities or simply collaterals. Collateral securities may take various forms, but may be grouped in three broad categories, namely, debentures, stocks, shares, bonds, etc. goods and documents of title to goods ; and immovable property. We shall examine these different types of securities—their value and what a banker has to do—in greater detail later on.

CHAPTER VII

BANKING STRUCTURE

In studying the organization of the banking system of a country, two questions are important One is the nature and scope of the individual bank's activities, and the other is the structure provided for inter-bank relations. The latter problem dealing with how far the banking system gravitates towards a cenral banking system, we shall examine in the succeeding chapter. We shall deal first with the organization of the individual banking institution. This in effect involves an examination of the question of unit *versus* branch banking.

The U.S.A. is the home of the unit banking organization. Under this system, the bank's operations are confined mostly to a single office, though a few are allowed to have branches within a strictly limited area. Historically, this system is the product of the American political philosophy of individualism. It is the financial counterpart of the independent commercial or industrial enterprise, which for long has been the dominant feature of the American economic system. It is also partly a result of the traditional fear of a 'Money Trust', and particularly the suspicion with which the Middle and the Far West have regarded the operations of the New York financiers. It may be recalled here that during the late forties of the last century, a well-developed system of branch banking existed in the South and Middle West of America. But it came to an end with the Civil War. The southern banks were ruined or voluntarily dissolved, while the

western banks were reorganized as unit banks under the National Bank Act of 1863. The McFadden Act of 1927 and the Glass-Steagall Banking Act of 1933 have introduced certain changes favouring extension of branch banking. Branch extension is, however, still subject to various limitations, and these laws do not provide for an extensive growth in the number of branches.

In contrast to the unit banks of the U.S.A., commercial banks in most countries are very large institutions with a network of branches scattered all over the country. England offers the best example of the branch banking organization. She has five big joint-stock banks, popularly known as the 'Big Five'—Lloyds, Barclays, the Midland, the Westminster, and the National Provincial—with 9,500 branches and controlling about three-quarters of the banking resources of the country. Canada has ten chartered banks, four of which control four-fifths of the banking resources. In Germany four joint-stock banks, popularly known as the 'D' banks—Deutsche, Disconto-Gesellschaft, Dresdner, and Darmsteadter National, and in France four commercial banks— Crédit Lyonnais, Société Générale, Comptoir National d'Escompte, and crédit Indusriel et Commercial—control by far the largest proportion of banking resources of their countries and hold positions in their respective countries comparable to that of the 'Big Five' in England.

India is usually referred to as a country with a unit banking system. This description is, however, no longer true. In recent years, there has been a spate of branch banking development in this country. The number of branches and offices of all banks has increased from 322 in 1918 to 2074 in 1940, as the following table will show :

NUMBER OF BRANCHES AND OFFICES

1918		1936		1943	
Presidency Banks	68	Reserve Bank	8	Reserve Bank	8
Exchange Banks	48	Imperial Bank	163	Imperial Bank	398
Indian Joint-stock Banks with paid-up capital and reserve of at least Re 1 Lakh	206	Exchange Banks	99	Exchange Banks	84
		Indian Joint-stock Banks with paid-up capital and reserve of at least Re 1 Lakh	849	Indian Joint-stock Banks having capital and reserves of at least Re 1 Lakh	2,561
	322		1,119		3,051

Although branch extension has been on a large scale in this country during the last few years, it cannot yet be said that banking facilities are adequate in relation to our population. This will be borne out by the following facts for 1936:

	Population per banking office	Deposits per head in shillings
India ...	2,76,000	112
England and Wales ..	3,900	1,164
U. S. A.	7,900	1,317
Germany	...	212
France*	20,000	165

The first table reveals that in the matter of branch extension, Indian joint-stock banks have taken the lead. Another noteworthy feature of the development of joint-stock banking in India is the very large concentration of resources in the hand of a few large Indian scheduled banks. The following table for the year 1943 will be found instructive in this connexion:

	Number of reporting banks	Branches	In 1,000 Rs.			
			Paid-up capital	Reserve	Total Deposits	Cash Balances
All class 'A' and class 'B' Banks	244	2844	21,11,69	8,52,61	3,59,88,78	89,61,78
Indian Scheduled Banks ...	57	1793	16,56,54	7,10,39	3,19,65,39	76,56,85
The Big Five ..	5	456	4,19,53	4,82,74	2,00,79,13	40,56,03
The Biggest Two	2	241	2,68,14	2,92,22	1,36,77,59	29,33,25

Class 'A' and class 'B' banks are those having a paid-up capital and reserve of Rs. 5 lakhs and over, and Re. 1 lakh and over and less than Rs. 5 lakhs respectively. The five big ~~Indian joint-stock~~ banks are the Central Bank of India, the Bank of India, the Allahabad Bank, the Bank of Baroda and the Punjab National Bank. The first two are the two biggest Indian joint-stock banks.

In regard to the concentration of resources in the hands of a few Indian joint-stock banks, it should be noted that the phenomenon is one of concentration of resources only, and not, as in Great Britain, concentration in banking and consequently of resources also. As distinct from the development in Great Britain, there has been no large-scale process of amalgamation of banks in India. On the contrary, there has been a steady growth in the number of banks as well as in the number of their branches. It is also noteworthy that, while in Great Britain amalgamation has led to the closing down of many inefficient and unprofitable branches, in India, on the contrary, there has been a spate of branch-expansion by individual banks with the result that many places, particularly in the mofussil, have

more banking establishments than can be economically and profitably maintained.

The amalgamation movement in Great Britain provoked a good deal of adverse criticism during the last Great War. So great was the fear that it might end in the formation of a money trust, which would be inimical to national interests, that a Treasury committee was appointed in March 1918 to examine the whole question. The committee came to the conclusion that 'the possible dangers resulting from further large amalgamations are material enough to outweigh the arguments against Government interference, and that in view of the exceptional extent to which the interests of the whole community depend on banking arrangements, some measure of Government control is essential'. The Government also brought forward a bill to give effect to the recommendations of the committee, but it was withdrawn before it became law in view of the fact that an agreement was arrived at between the banks and the Government to the effect that no further arrangements for amalgamation would be entered into without the consent of the Treasury.

Unit and Branch Banking Compared

Before the development of large-scale business, a unit banking system had many advantages and had to its credit much good work. In the U.S.A., for example, it fostered the rapid growth of the country. Its local control and local outlook provided a sympathetic understanding of local needs. But it proved helpless before broader forces. The rapid development of transport and communications and the growth in the size of business establishments created conditions with which a unit banking structure could no

longer cope. Not only did the unit bank not possess sufficient resources to finance the requirements of big business, but further, large-scale operations called for credit investigation of a kind that a small local bank was unable to make. In the second place, as a result of the development of communications, local banks have lost much of their best business to adjacent large centres with consequent adverse effects on diversification and liquidity of their assets. Thirdly, earnings have also been affected by relatively higher operating expenses and larger losses and depreciation.

The disadvantages of a unit banking system are usually the advantages of a branch banking system. But in comparing one with the other, it should be remembered that unit banking has the correspondent system, under which unit banks may have accounts with other banks in various places, and is thereby enabled to enjoy some of the advantages of branch banking.

Branch banking has, generally speaking, the advantages and economies of large-scale operation. The advantages are those of division of labour. In the first place, branch banking ensures economy of reserves. We have already mentioned that the maintenance of an adequate reserve is essential to a banker. A large bank can manage with a comparatively lower cash reserve per office, as one office in difficulty can draw upon the reserves of other offices. The disadvantage of a unit bank is modified to some extent by the existence of the correspondent system. This means, however, that it has to maintain deposits with correspondent banks, which yield little or no return. Secondly, concentration of financial resources in the case of a branch bank enables a more rapid mobilization of resources in an emergency as well as a more effective seasonal movement

of funds. Such rapid movement of funds has, in the third place, the effect of making interest rates tend to uniformity over wide areas. Fourthly, branch banking enables risks to be spread geographically. By thus averaging risks, it reduces them, and thus minimizes the danger of failure. It may be argued that in times of general trade depression, both the unit and the branch banks will suffer equally Since, however, even during periods of general depression, capital goods industries are likely to suffer most and first, unit banks, if they are localized in such areas, will be very adversely affected. In addition to general trade depression, particular industries may suffer owing to changes in fashion or technique. Unit banks localized in such areas may under such conditions have to incur heavy losses and even collapse. Thus, even prior to the economic crisis of 1929 when boom conditions generally prevailed, chronic depression in certain sections of American agriculture was responsible for the failure of many small local banks. During the same time, English branch banks were incurring heavy losses in the Lancashire cotton industry. They were able, however, to make up such losses by profits made elsewhere, and had not to suffer any débâcle. Fifthly, branch banking helps to raise banking standards, for a big bank can afford to pay a competent banking staff of experts who will be able to understand technical problems and provide broad judgement. In the sixth place, the cost of remittance business is greatly decreased under a branch banking system. A unit bank with correspondents at other places can also offer this service, but not at such low cost. Seventhly, branch banking ensures economical expenditure and the rendering of better services throughout the country. For one thing overhead costs will be lower. For another, some banks

can, if necessary, be run at a loss. Such loss is more than made up by profits earned by other branches.

As against these patent advantages of branch banking, certain problems exist. For example, if a large bank should fail on account of incompetent management, widespread disaster may follow. Further, proper examination may sometimes be rendered difficult owing to the physical size and ramifications of some branch banks. Thirdly, under the unit banking system, failure of one bank has only the effect of eliminating one weak spot. Under the branch system, a weak branch may be permitted to continue for a long time with possible deleterious effect on the bank as a whole Thus, it is said that the unit bank has to meet its obligations, whereas the branch banking system may sacrifice liquidity to carry along a bad situation. Incidentally, this is an argument in favour of extending branch banking by absorbing existing small local banks rather than by establishing new branches which will compete with existing local banks. In the last place, the claim that the unit bank has an advantage in that its manager knows local conditions and therefore is in a better position to judge which particular businessmen are worthy of assistance may be mentioned. As against this, it may be argued that such a circumstance may also have a contrary effect The manager of a local bank may find it very awkward to refuse a loan to an incompetent and dishonest member of a family with whom he may be on intimate social terms. The local manager of a branch bank, on the contrary, may refuse the loan in such a case by putting the whole blame on the head office, without the social awkwardness which would arise if he had the sole responsibility for the decision.

The advantages are, therefore, very much in favour of

the branch banking system With the growth of large-scale business, it is no wonder that the trend of banking development in almost every country is the growth of big banking institutions with a network of branches spread all over the country.

In the U. S. A., this normal development has been held in check by legal restrictions. But even in the U. S. A., there has been some notable change in the unit banking system during the last few years. The development of chain and group banking has, for example, linked together under one control a number of institutions located at different places. By chain banking is meant the 'control of a number of banks (each of which retains its own identity, capital and personnel), through stock ownership or otherwise (such as through interlocking directorates and officers) by the same individual or group of individuals who exercise the prerogatives of majority stock-holders'[1]. Group-banking is very much like chain-banking. Both operate a number of ostensibly independent banks as a more or less cohesive unit. In fact, the Federal Reserve Board and the Economic Policy Commission have grouped the two together. The Controller of Currency has, however, made the following distinction: 'The principal factor in group-banking is that each group is centred around a city or metropolitan bank through means of a holding company, which owns the majority of stock of each bank, thereby creating a system of banks more or less integrated in management with the central bank of the group.'[2] Both chain and group banking have the object of securing some of the advantages of branch banking within the limitations imposed by law in the U. S. A.

[1] Steiner: *Money and Banking*, p. 591.
[2] Quoted by Steiner op. cit., p. 593

CHAPTER VIII

CENTRAL BANKING

IN the last chapter we examined the nature and scope of an individual bank's activities. We shall now consider the structure provided for inter-bank relation. This structure in most countries is built upon what is called 'the central banking system'. In studying this system, it should be borne in mind that there is no standard central bank pattern. The American system, for example, differs from that of other countries Again, the economic and market conditions of particular countries cause variations in the operations of different central banks.

Bearing in mind such possible differences in the organization and operation of different central banks, it may be stated that the principal duty of all central banks is to maintain stability of the monetary unit in the best interests of the general community. The distinguishing characteristic of a central bank is public service,—the maintenance of the stability of the nation's credit structure and the promotion of its best economic interests. This object is also clearly stated in the preamble to the Reserve Bank of India Act, which says that 'it is expedient to constitute a Reserve Bank for India to regulate the issue of bank notes and the keeping of reserves with a view to secure monetary stability in British India, and generally to operate the currency and credit system of the country to its advantage'.

To fulfil this object, a central bank is endowed with certain special powers. For example, it has usually the sole right of note issue ; it is the banker to the government,

the custodian of the nation's reserve and the lender of the last resort. But there are also corresponding limitations upon its activities directly following from its role as a central bank. It must not, in the first place, be actuated by considerations of profit, but must serve the collective interests of the community. Secondly, it must maintain its assets in the most liquid form, for it is the lender of the last resort. Thirdly, it should not enter into direct competition with the ordinary commercial banks. Such competition would be both unfair and undesirable. It would be unfair because, as the central bank holds government balances, it could use these funds competitively to the detriment of commercial banks. It would be undesirable because such competition would rouse the hostility of commercial banks and thus render its task of controlling the general credit situation difficult.

✓ THE CENTRAL BANK AND THE GOVERNMENT

Although the central bank is almost universally a privately-owned institution, it has to co-operate closely with the government. It is the government which is ultimately responsible for controlling the monetary system of a country. This control is exercised through the Treasury, which is a government department. In practice, however, the larger aspects of the financial policy of the Treasury are influenced by the advice tendered by the central bank.

The government in a modern state can wield a great influence over conditions in the money market. It has, for example, great powers over the volume of internal long-term issues, the volume of external long-term lending and the effective short-term rate of interest by means of Treasury Bill policy. Where there is an Exchange Equalization Fund, which is usually operated by a department of the

Government, the state can influence the whole money market in various ways. In addition, government activities probably account for 25 per cent of the total national economy. All these activities have an important bearing upon the currency and credit position of the country, which in effect is the responsibility of the central bank. It is necessary therefore that in all these matters the government should turn to the central bank for advice. In some countries consultation with the central bank by the government is obligatory in matters concerning currency and credit; and in other countries constant consultation has become the rule by a traditional development. The actual influence that a central bank may have, depends, of course, largely upon its standing and the moral and technical qualities of its authorities. But it is a mistake to think that a central bank can by itself establish orderly monetary conditions if the government carries on an unwise policy leading to a serious deterioration of its own credit.

The government and the central bank may disagree upon questions of policy. Thus the immediate interests of the Treasury and the views of the central bank may clash where the government wants to borrow money and therefore wishes to keep interest rates down, while the central bank may consider that general economic conditions demand that interest rates should be maintained or raised. Or, the government may want to borrow more from the central bank than the latter considers desirable. In such cases, the government's will must prevail if it cannot be persuaded to agree to the advice tendered by the central bank. If the Governor of the central bank maintains his opposition, he will be forced to resign and will be replaced by somebody more amenable

The following opinion on the relationship between the

central bank and the government, of the Royal Commission on Money and Banking in Australia is worth quoting: 'Where there is a conflict between the Government's view of what is best in the national interest and the Board's view, the first essential is a full and frank discussion between the two authorities with a view to exploring the whole problem. In most cases, this should ensure agreement on policy. . . . In cases in which it is clear beyond doubt that differences are irreconcilable, the Government should give the Bank an assurance that it accepts full responsibility for the proposed policy and is in a position to take and will take any action to implement it. It is then the duty of the Bank to accept this assurance and carry out the policy. . . . This does not imply that there should at any time be interference by the Government in the administration of the Bank.'

FUNCTIONS OF CENTRAL BANKS

The principal functions of a central bank may be enumerated as follows:

1 *To serve as a bank of issue and assume responsibility for maintaining currency on a solid and secure footing.* To this end, the central bank is granted either the sole right of note issue or at any rate, a partial monopoly thereof. This exclusive privilege is of particular importance on the Continent and in countries like India, where the use of cheques is not so widespread as in England and America. Currency being an important medium of payment in these countries, the sole right of note issue is a powerful weapon for controlling the monetary supply in the country. It may be mentioned, however, that the gold standard and the exchange standard systems provide for some method of automatic and obligatory issue and redemption of notes.

Thus, under the gold standard, notes can always be obtained against gold and under the exchange standard system against some foreign currency. In our country, rupees can always be had against sterling or *vice versa*. But a central bank has normally also other methods of issuing or withdrawing notes at its disposal, for example, through rediscounting of bills, granting of advances or purchase or sale of securities.

In the issue of notes, the main requirements are uniformity, elasticity and security. Uniformity is obtained by granting the sole right of note issue to the central bank. Elasticity is secured by basing the issue of notes partly on gold and partly on trade bills, whereby note circulation is brought into some relation with the volume of business. Security is assured by requiring a minimum cover in gold of, say, 35 or 40 per cent, sometimes inclusive of foreign exchange, and the remainder, in government securities, trade bills or other commercial paper.

2. *To act as the sole or principal banker and financial agent generally of the government.* The central bank holds on deposit the government's temporary surplus funds, assists government loan floatations, disburses government funds, and finances the Treasury at certain times in anticipation of heavy tax collections by means of advances or discounts of Treasury Bills. The accommodation which the central bank may provide to the government to tide the Treasury over periods of temporary stringency must be strictly limited in scope. For example, it should not exceed a certain proportion of the total budget revenue of the year nor should it be granted for a long period. The general rule is that advances should be repaid within the budget year, or at the outside within three months after the budget year.

3 *To operate as a clearing house for other banks.*—The central bank usually acts as a clearing house for other banks, and settlements are effected by drawing cheques upon it.

4. *To act as a reserve bank and hold a portion of the cash reserves of commercial banks, either by law or tradition.*—The holding of a cash balance with the central bank is obligatory in only a few countries. In England, a fairly constant cash reserve of the clearing banks is maintained with the Bank of England not by law but according to firmly established custom and forms the basis of England's domestic credit structure. The holding by commercial banks of minimum cash balances with the central bank was discussed in the year following the last Great War. No such obligation was imposed in the case of central banks established in Europe after the War ; but when central banks were established in Canada, India, New Zealand and the Argentine, certain obligatory minimum cash balances were prescribed for the following reasons :

(*a*) The maintenance of balances by commrecial banks with the central bank may serve the purpose of strengthening the liquidity of the banking system.

(*b*) The holding of such balances may be used as a basis for influencing the credit conditions of the commercial banks ; an increase in the banks' cash resources giving an impetus to expansion of credit, and a reduction of those resources calling for a restriction ; and the percentages prescribed for cash requirements of the banks may also be varied from time to time.

(*c*) Lastly, the introduction of compulsory minimum

reserves held by the commercial banks may be an indirect method of providing the central bank with increased liquid resources.

5. *To act as a bankers' bank, to rediscount bills of exchange, promissory notes and other commercial paper or grant advances against approved securities presented by commercial banks.*—This is an important function of the central bank. By these operations, it may (*a*) supply credit against domestic assets (e.g. home bills) and be 'the lender of last resort', helping to ensure the liquidity of the credit system, and (*b*) influence domestic credit conditions inasmuch as the official discount rate exercises a certain influence on other rates in the market. In most countries the central bank deals only with other banks and not directly with the public. A notable exception is the Bank of France. Although there may be no statutory provision in many cases obliging central banks to deal with commercial banks only, in practice, however, they limit their dealings to banks, or apply to banks a lower rate than to other customers. Quite exceptional is the Bank of England, which deals not with joint-stock banks, but with the discount market. Among eligible paper, it is generally held that only first class commercial bills with a maximum currency of three months should be accepted, but, with certain central banks, an exception has been made in respect of agricultural bills, which may be accepted with a currency of six or even nine months. The Reserve Bank of India, for example, may accept agricultural paper with a nine months' maximum currency. The 'paper' which is to be accepted as eligible for discounting should be of a liquid and self-liquidating character for if the resources of a central bank become frozen, its power of control over the volume of credit will be seriously

restricted. For the same reason, the advances of the central bank should also be against assets which can be easily liquidated. It is only within very narrow limits that a central bank should, if at all, grant advances against other assets. The object of a central bank is, not to provide facilities for individual firms or for the government, but to increase or restrict its discounts and advances according to the requirements of the general credit position. This is implied in its function as a lender of the last resort.

6. *To undertake that it will endeavour to maintain the entire credit structure on a sound basis, and control the volume of credit.*—To this end, the central bank should seek to expand or contract the volume of credit in accordance with the needs of business and in the interest of national economic welfare. The central bank acts as a regulator and stabilizer of the monetary supply in the country. It controls both currency and credit. But as bank credit is the most important medium of payment in practically all advanced countries, credit control constitutes in fact the principal task of the central bank. How this is effected we shall examine in greater detail in the succeeding chapter.

commercial banks. Joint-stock banks can also create deposits by acquiring fresh assets. The problem of central banking control is therefore essentially one of regulating the bank credit which commercial banks can create. We shall study this problem under two sets of circumstances, namely, in an advanced country with an organized money market like England and America, and in a country with no organized money market such as India, Canada or Australia. England offers the classical example of central banking control.

As the commercial banks are the principal agency for the creation of bank credit, a central bank's control over the volume of monetary supply must be exercised through its power of regulating the operations of these banks. Here two factors facilitate the work of the central bank. In the first place, the commercial banks' power to create deposits depends upon the amount of their cash reserves. Secondly, the central bank possesses considerable power over the supply of cash.

By cash, commercial banks usually mean till money and balances with the central bank. It consists, therefore, of metallic currency, notes and deposits with the central bank. Of these, metallic currency is unimportant, and bank notes also are, say, in England, very much like small change. Commercial banks, however, aim at maintaining their till money and deposits with the central bank at the lowest, as these are idle assets. But they maintain a certain proportion between their cash and deposit liabilities, and their deposit liabilities to the public are determined largely by their action in acquiring assets. Therefore, the extent to which they will be able to expand their deposit liabilities to the public will depend upon the magnitude of their cash reserves. Thus, as Sayers says, 'If the

Bank of England can determine the volume of Bankers' Deposits with itself, and can supply whatever volume of notes is appropriate to that level of Bankers' Deposits, the Bank of England will be controlling the general operations of the commercial banks'[1]. As commercial banks draw out notes only to the extent that is necessary to meet customers' demands, the important point in controlling bank credit is the power of the central bank over the volume of commercial banks' balances with itself, which these banks regard as equivalent to cash.

HOW CASH CAN BE CONTROLLED

The Bank of England can alter the deposits of commercial banks with it in three ways, namely, (a) purchase of Treasury Bills and Government securities in the market by the Bank of England ; (b) purchase of gold from ordinary bullion dealers by the Bank of England ; and (c) an excess of payments to the Government over payments by the Government. In the first case, purchase of Treasury Bills or Government securities means payment by the Bank of England to members of the public or other institutions or banks. These cheques have the effect of swelling Bankers' Deposits with the Bank of England, while the holding of Government securities of the Bank also proportionately increases. The increased Bankers' Deposits mean that commercial banks have a larger cash reserve with which they can acquire fresh assets, which would create deposits and thus increase the supply of money. Purchase of gold from ordinary bullion dealers has the same effect as in the first case. The third case has the effect of increasing Public Deposits at the expense of Bankers' Deposits. As commercial banks' cash is depleted, they will set about

[1] *Modern Banking*, p 97

to restore their cash position by calling in loans and contracting their deposit liabilities. The sale of Government securities, or of bullion in the market, or the excess of Government expenditure over receipts will have consequences in each case contrary to what has been described above.

We have seen that the Bank of England can, if it likes, regulate the cash reserves of commercial banks and thus the volume of monetary supply. But as it is at the same time the lender of the last resort, it can be approached by the commercial banks through the discount market to replenish their cash reserves. Thus, it would appear that as a lender of the last resort, the Bank of England may nullify its action in controlling the cash reserves of commercial banks. But there is one very important point in this context. When the Bank of England is approached for funds by the market, it means that its rate, that is, the Bank rate has become effective, for funds can be had from the Bank of England against eligible paper at its published rates only. When the discount market approaches the Bank of England for funds in view of the fact that commercial banks have called back loans given to it, the market is colloquially said to be 'in the Bank' and the Bank rate policy is said to have been effective. When the Bank rate policy is effective, it means that the Bank of England has complete control over the market.

Methods of Controlling Credit

Of the methods available to a central bank for controlling credit, the most important are the Bank rate and open market operations. Although a rise in the Bank rate is intended and often actually leads to a contraction of credit, and a fall has the opposite effect, there is no inherent reason

why this should be so. The question whether there would be an expansion or contraction of bank credit depends upon the behaviour of the market rates of interest. If the change in the Bank rate does not reflect or anticipate a change in market rates of interest due to a change in the supply or demand in the loan market, it may have no effect whatsoever on the market. The Bank rate, therefore, achieves its effect mainly through a convention that other rates quoted in the money market shall ordinarily be related to it. There is, however, the further point that commercial banks are aware that the central bank has other weapons at its disposal for making its rate effective, and they may therefore agree to follow the lead given by the central bank in spite of the fact that market conditions may not necessitate such a course of action.

A central bank may conduct open-market operations to supplement a Bank rate policy, or even independently with a view to regulate credit conditions. By open-market operations are meant the purchase and sale of securities by the central bank in the open market. Open-market operations may be of the following various kinds:

(*a*) They may be undertaken to make a change in the discount rate effective. In countries where the operation of joint-stock banks is largely dependent on their cash ratio, the enlargement or contraction of the cash basis by means of open-market operations is a fruitful method of influencing credit conditions.

(*b*) They may be made by monetary authorities to offset an inflow or outflow of funds in relation to foreign markets. In England, such operations were regularly made before the last war through the agency of the Exchange

Equalization Account with a view to counterbalance the influence on the internal credit structure of movements of short-term funds and also of seasonal variations.

(c) They may be conducted to offset government receipts or expenditure, for it is desirable that the Government by its operations, should not deprive the market of current funds Open- market operations for this purpose are not necessary if the Government keeps its funds largely with commercial banks as in the U. S. A.

(d) They may be undertaken not only to make a change in the discount rate effective, but also to assist in the lowering of long-term rates of interest. In England, for example, in 1932 the expansion of credit was made primarily to help business by the cheapening of money, but advantage was taken of the subsequent decline in long-term rates to carry through the big conversion of War Loans.

We may also mention some other devices which a central bank may employ to control credit. They are:

(1) *Moral suasion.*—In England, says Coulborn,[1] moral suasion has particular reference to the rate and destination of investment. The Bank of England has great powers to influence overseas issues, and the exercise of such powers is motivated by a desire to influence the foreign exchanges. In so far as the Bank may be able to control new issues, it will be in a position to curb an incipient boom. In the U. S. A., the

[1] *An Introduction to Money*, p. 246.

Reserve Banks make a more effective use of this weapon for restricting credit to individual member banks, which, in their opinion, have been unduly expanding credit. This has been made possible by recent legislation which has added a further objective to their lending policy, namely, 'maintenance of sound credit conditions', under which loans may be refused to any bank which is making an undue use of bank credit 'for the speculative carrying of or trading in securities, real estate or commodities, or for any other purpose inconsistent with maintenance of sound credit institutions'.

(2) *Alteration of cash ratios.*—This device is particularly useful in countries where commercial banks have to maintain statutory deposits with the central bank, and where, further, the latter is given power to alter the proportion of deposits that have to be maintained with it. It has been used, for example, in the U. S. A., not with a view to altering the volume of credit at once, but to absorbing member banks' excess reserves which threaten inflation. In England, joint-stock banks voluntarily maintain between 4 and 5 per cent of their deposits with the Bank of England. If these reserves were made legally binding and the Bank were also given authority to alter this percentage, the Bank would be invested with a powerful means of control over joint-stock banks. It may be mentioned that the Macmillan Committee expressed the opinion that statutory embodiment was unnecessary, but that the Bank should represent to the joint-

stock banks the cash percentage it thought appropriate, and that these banks should alter their cash ratios accordingly. The alteration of cash ratios, it is claimed, will have an effect even superior to open-market operations, inasmuch as it will affect all parts of the credit structure, short and long-term securities, bills, advances etc., whereas open-market operations fall with disproportionate incidence upon short-term securities, since these operations are by custom limited to this market.

(3) *Publicity*.—In England, the Macmillan Committee recommended a greater degree of co-operation and mutual consultation with joint-stock banks. 'It is desirable' said the Report, 'that the clearing banks should be made aware in the plainest possible manner whether the general tendency of policy of the Bank of England is towards a relaxation or contraction of conditions of the domestic market'. It is expected that the joint-stock banks will base their own policy in accordance with such information. In the U. S. A., the views of the officials of the Federal Reserve System with respect to financial conditions are made public through official publications of the System or through other forms of public statements. These statements have sometimes constituted an instrument of policy fully as effective as specific action which might have been taken. Thus, the Federal Reserve Board issued a statement in February 1929 warning against excessive use of credit for security speculation.

EFFECT OF CHANGES IN BANK RATE

A change in the Bank rate affects both the domestic and the external situations. When, for example, the Bank of England raises the Bank rate and sells, if necessary, securities to make it effective, two results tends to restrict the volume of credit. In the first place, market rates of interest will rise with the Bank rate. This, as we have already stated, may be a sympathetic rise in anticipation of the fact that the Bank can make the higher rate effective by selling securities. In the second place, long-term interest rates also tend to rise with the short-term rates If the latter rise, while long-term rates remain stable, short-term securities become more attractive, with the result investors sell their long-dated securities and invest funds in short-term securities This process drives down the capital value of long-dated securities, which in effect means a rise in long-term interest rates. If the rise in interest rates seriously cuts into profits, production and employment will fall off and prices will also have a deflationary trend. If, in spite of higher interest rates, profits continue to be satisfactory, the upward tendency in production, employment and prices may continue.

A fall in the Bank rate, supported sometimes by purchases of securities, is intended to make conditions in the market easy. Interest rates fall, while purchases of securities have the effect of increasing the cash reserves of commercial banks. These are conditions which may be described as creating a borrowers' market, for they favour borrowers of money. There is no certainty if they will lead to more active business conditions, for, it is always more difficult to talk the market into prosperity than it is to restrict credit and bring about a deflationary tendency.

We have so far described the effect of a change in the Bank rate on the internal situation. It also affects the external situation, and the external situation is materially influenced by changes that take place in the domestic situation. A rise in the bank rate, or dear money, reacts on the ~~external situation~~ in the following manner:[1]

(i) Dear money tends to diminish the net amount which a country lends abroad or to increase the amount which it borrows. Both short-term lending and long-term lending are affected, but it is the former which feels a change sooner and more sensitively. Thus there is an immediately favourable effect on the country's balance of international payments and hence on its foreign exchanges and its gold reserves. This assumes that the change in the Bank rate is a change relative to rates elsewhere and is not merely keeping pace with changes elsewhere.

(ii) Some part of the purchasing power which dear money tends to curtail will have been spent on imports or on home-produced goods which are now released for export. Thus dear money has a favourable effect on a country's visible balance of trade, which again has a favourable effect on the country's balance of international payments and hence on its foreign exchanges and on its gold reserves.

(iii) If the fall in prices which dear money brings about continues for any length of time, it necessarily puts a pressure on producers to reduce costs, including wages if necessary.

[1] Macmillan Committee's *Report*, pp. 95-96

> When costs as well as prices have fallen, the help to the country's visible balance of trade resulting from the fall of prices will be on a more durable and reliable basis.

Thus, the effect of a change in the Bank rate on the foreign exchange market is felt through the short-term and long-term money markets and the balance of trade. The immediate effects are felt through short-term movement of funds. In fact, movement of these funds may rectify any adverse tendency in the balance of international payments for short periods. But, the flow of short-term funds depends upon two essential conditions: the existence of a good market for short-term funds in the centres affected and confidence in the future of the foreign exchange value of the currency concerned. The first condition is best satisfied by the London bill market, where accepting houses guarantee trade bills and the British Government, the Treasury Bills. In other big international financial centres such as New York, Paris and Berlin, the position is not dissimilar. But among the chief borrowers in most centres are the commercial banks, which should, therefore, possess an international reputation. The question is not whether they are or are not really sound, but that they should be internationally recognized as such. The second condition is also essential, for nobody would like to hold or invest in a foreign currency the future exchange value of which is considered uncertain. As Sayers puts it: 'A differential of 1 or 2 per cent per annum on a three months' loan does not attract lenders if they fear that within three months the currency may have lost 20 per cent of its value in terms of lender's home currency. Whether their fears are rational or not does not, at a given moment, matter. The fact

that they have fears is enough to stultify the action of the Bank rate weapon'.[1]

The mechanism of credit control by a central bank described above is really applicable to conditions as they existed before 1914, say, in Great Britain. Since then, circumstances have greatly changed, and the effectiveness of the Bank rate has also suffered. The opinion has therefore been expressed that although the Bank rate will always have its uses, 'the future lies not with those who would rely on a refurbishing of the Bank rate, but rather with those who are prepared to add more weapons to the armouries of monetary authorities'.[2]

UNORGANIZED MONEY MARKET AND CENTRAL BANKING CONTROL

We have studied the mechanism and methods of credit control in an organized money market. We shall now examine the problem of credit control in an unorganized money market such as the British Dominions and India. The important peculiarities of the banking systems of such countries are a low development of the banking habit and offices. an absence or unsatisfactory state of the short-term money market, and the comparative ineffectiveness of the central bank, partly because it is newly established and partly because it is superimposed by statute and has had no tradition behind it. Of these peculiarities, the second and third are particularly relevant to Indian conditions. Canada and Australia have well-developed banking systems and the cheque habit in these countries is also prevalent. In India in recent years there has been a rapid progress in banking development, although, considering the vastness of the

[1] *Modern Banking*, p 181.

[2] op. cit., p. 185.

country and its population, banking facilities are still far from adequate. Further, the cheque habit has also been growing as a means of settling debts. Of the three traits mentioned above, the chief characteristic of an unorganized money market such as India is that there is no adequate organization for the mobilization of all surplus short-term funds in the market for the purpose of their effective utilization. The consequence is that these funds are not distributed among the various component parts of the money market in the most economical manner, with the result that a situation of acute stringency in one sector may co-exist with easy conditions in another. The outward manifestation of this phenomenon is often the absence of a co-ordinated relationship between the various interest rates.

In an unorganized market, a bank rate policy may not prove effective. The success of this policy depends upon the fact that the commercial banks are generally indebted, whether directly or indirectly, to the central bank. In such circumstances, the central bank can force the commercial banks to follow the lead given by it in respect of short-term interest rates. But when a central bank is superimposed upon an existing banking system, it is not easy to lead the commercial banks quickly into indebtedness to the central bank. Open-market operations in unorganized markets may further have only a limited scope, for the Stock Exchanges in those markets may be unable to complete very big deals. Under such conditions, Sayers[1] suggests certain possibilities of making the central bank's control over credit effective. In the first place, there is a possibility of the central bank securing a change in the composition of its liabilities by taking advantage of its position as a banker to the government. What is suggested

[1] *Modern Banking*, p. 293-297.

is that in a country not on the gold standard, or in a country on the gold standard when the central bank cannot reduce its non-gold assets when gold is flowing in, the central bank can restrict the cash basis by raising government balances or deposits with it. This cannot of course be done by the central bank on its own initiative, and is possible only with the full co-operation of the government operating through the Treasury. It should be added that the variations in public deposits to be effective should be produced through revenue surplus and deficits and not by means of Government debt operations. In the second place, the central bank can be given power, as in New Zealand or the U. S. A., to vary the ratios of commercial banks' compulsory cash reserves to their deposit liabilities. By this means, the central bank can enlarge or contract the cash reserves of commercial banks by lowering or raising the percentage of their statutory deposits with it. In a non-gold standard country, the central bank may further be given power to regulate the foreign exchange value of the country.

In an unorganized market, although the discount rate loses much of its importance, it is not without significance and serves a useful purpose. De Kock[1] mentions that the discount rate of central banks in such markets has a threefold significance. In the first place, the discount rate, particularly in countries where central banks have large dealings with the public, indicates the rate at which the latter can obtain accommodation from the central bank against specified securities. But central banks, even when they have power to deal directly with the public, do not usually exercise it and confine their dealings to commercial banks only. Even under such conditions, the influence of

[1] *Central Banking*, p. 204-11

the discount rate is exerted indirectly inasmuch as other credit institutions generally adapt their own rates to changes in the official discount rate. In the second place, the discount rate represents the basis of the rates at which commercial banks can obtain accommodation from the central bank. In the third place, the psychological value of the discount rate is of great importance to the central bank as an instrument of credit control. The degree of its importance evidently depends upon the prestige of the central bank and the co-operation it can secure from the commercial banks. When this co-operation exists in large measure, a conventional relationship between the discount rate and other market rates may be gradually evolved.

CHAPTER X

REGULATION OF BANKING

As a business, a bank stands in a category by itself. It has an exceptional social significance. Its operations affect the public interest and have an important bearing on the common weal. Its importance is derived from the fact that it supplies a general circulation medium in the shape of bank deposits, and further that the value of this medium is materially dependent upon banking policy. The bank also wields immense power in view of its control over loanable funds. It directs the channels of investment and therefore the types of business that will develop. Any error that the bank may make affects not only itself but also the entire community. A bank failure means not only loss to depositors and shareholders, but also deprives the general public of credit facilities. For all these reasons a bank is looked upon as a public utility and as such liable to state regulation. Further, as the state should have the final say in monetary policy, it is but reasonable to expect that banks should be subject to state control. The need for control is greater in countries where a system of unit banking prevails, and the general public is ignorant and illiterate. Admitted that the state must have some control over the monetary supply and policy of a country, the important question is what should be the nature and content of such control. The extreme form of control that has been proposed is that of nationalization of commercial banks. This proposal has not found much favour in practice. But commercial banks practically all over the world have been made subject to some small

or large measure of control. We shall briefly illustrate the important features of commercial banking legislation in certain countries.[1]

The regulation of banks includes control over their formation, restriction of their operations, administration of their liquidation in the event of failure and general supervision.

Legislation to secure adequate capitalization of a bank may take one or more of four main methods. Firstly, law may provide for a fixed minimum capital. In Sweden, Belgium and Canada, there is provision for statutory minimum capital. A similar provision is also included in the Indian Companies' Act of 1936 relating to banking companies Secondly, it may be stipulated that the capital should be a fixed percentage of liabilities, as in Switzerland. This is not a very happy provision inasmuch as a big bank with branches and offices over a wide area does not require as high a ratio of capital to liabilities as a small local bank. Thirdly, the amount of capital may be made to depend upon the population of the place in which a bank is situated, as in the U. S. A. A fourth method is followed in Spain, where the capital for each bank is fixed according to its particular circumstances.

Legislation with regard to the operations of banks may be grouped under the following heads:

1 *Surplus.*—In many countries, law provides for the maintenance of a surplus and regulates its amount In the U. S. A., a national bank may not commence business unless it has a paid-up surplus of 20 per cent of its capital In addition, every national bank, before it declares a dividend, must carry forward 10 per

[1] See Allen, etc *Commercial Banking Legislation and Control*, pp. 3-52

cent of its net profits until its surplus equals its capital. A similar provision is contained in the Indian Companies' Act of 1936 relating to banks. In certain countries legislation is directed towards the special protection of savings deposits, which are believed to be usually made by small depositors, for example in Argentine and Switzerland. Unless, however, it is also stipulated in what form of assets these surpluses should be held, it may be found in an emergency that they have, like capital and deposits, become immobilized.

2. *Cash Reserves and Liquidity.*—Commercial banks in America, India, Germany, Canada and other countries are required to maintain a statutory cash deposit with the central bank. The ratio of cash deposits may vary from country to country and between different types of banks within the same country. The maintenance of cash deposits with central banks by commercial banks may have two objects, to provide the central banks with funds, and to ensure liquidity of individual banks. A statutory reserve ratio does not, however, of itself ensure liquidity. The existence of a statutory deposit does not necessarily enable a bank to meet exceptional withdrawals. Whether the position of a bank is liquid or not does not depend on its statutory cash reserve, but on the nature of its assets as a whole.

3. *Restriction on mixed banking.*—Mixed banking is prevalent in Germany and some other coun-

tries on the continent. In recent years, there has been a tendency away from mixed banking in favour of pure commercial banking. This trend is noticeable in some of the recent bank statutes. Thus, in Belgium, where mixed banking was once very widespread, the law of 1934 forbids a bank, which accepts deposits at interest repayable in two years, to hold shares in or participate in any commercial or industrial enterprise, with certain minor exceptions. Some restriction on commercial or industrial participation has been imposed in Sweden, Norway and even Germany. In the U. S. A., the Banking Act of 1933 prohibits member banks from being affiliated to or controlling any corporation or association engaged principally in the issue, floatation, underwriting, sale or distribution of stocks, bonds, debentures and other securities The purpose of such prohibition of or restriction on mixed banking is as much to ensure the liquidity of commercial banks as to safe-guard them against undue risk of loss.

4. *Control of assets.*—In certain countries, legislation seeks to regulate the assets of commercial banks. It is usually negative rather than positive in character. For example, certain kinds of assets or transactions are forbidden. A common restriction is on the ownership of a real estate other than premises, for example, in the case of American national banks and in Sweden. In Germany, permanent participations and investments in property and building

may not exceed capital and reserves. Restrictions are also sometimes imposed on loans that may be allowed to a single customer by banks in Germany and Denmark and by American national banks. In certain countries, there is statutory provision in respect of the margin that must be maintained against loans granted.

5. *Restriction on over-banking and bank amalgamation.*—In many countries, legislation gives power to responsible authorities to control the establishment of new banks with a view to prevent over-banking. In Germany, the licensing authority, the Banking Commission, may refuse to grant a licence for the formation of a new bank if certain conditions are not fulfilled. In Canada, a special Act of Parliament is necessary for the establishment of a new bank. In the U. S. A., the Controller of Currency has considerable discretionary powers in granting charters to new national banks. Restrictions are also imposed in many countries on the opening of new branches, for example in Germany, Italy and the U. S. A.

Bank amalgamations are controlled by statute in many countries. In Norway and Sweden, official consent is required. Even in England the consent of the Treasury is necessary. In the U. S. A., combinations are restricted by legislation directed against branch banking.

On the subject of restrictions on bank formation and merger, Allen makes the following observation,[1] 'Universal as are the laws res-

[1] *Commercial Banking Legislation and Control*, p. 37.

tricting the formation, amalgamation and branch banking activities of commercial banks, it cannot be said that they have generally exercised any great effect upon the banking structure of the different countries. They have usually been introduced when the movement which they intended to check had run its course.'

6. *Control over interest rates.*—This control may extend over interest paid on deposits or charged against advances. In the U. S. A., the 1933 Act prohibits the paying of interest on demand deposits, that is on deposits repayable within a month. In Argentine, interest paid on sight deposits must be at least three points less than the Central Bank's rediscount rate and on savings deposits at least one point less. In certain countries, interest charged on loans is also controlled with the object of regulating the price of credit, especially where a central bank has no actual control or where no conventions as to rates exist. In Germany, for example, the maximum rates of interest on deposits and loans, while ostensibly fixed by the banks, are really under the control of the Banking Commissioner. Canada has still a usury law, and no bank may charge a rate of interest exceeding 7 per cent.

Liquidating Institutions.—Of institutions set up to help banks in difficulty or banks which fail, the Reconstruction Finance Corporation established in the U. S. A. in 1932 deserves special mention. It has rendered signal service to banks in difficulty, partly by furnishing new capital where

capital has been deficient and partly by providing loans against assets that are not eligible for rediscount at the Federal Reserve Banks In this way, the Corporation has acquired considerable influence over banks it has helped. In Argentine, the Instituto Movilizador was established in 1935 for the purpose of taking over the frozen assets of commercial banks A similar institution exists in Belgium and in Austria.

Supervising Authority

There are three main types of supervising authority. Firstly, inspectorates appointed by the Crown, which work in close co-operation with the government. Control is exercised by the state, and the central bank has little or no voice in the matter. This is the system which obtains in the Scandinavian countries and also in Canada. Secondly, there are the Banking Commissions composed of several members in countries like Belgium and Switzerland. Thirdly, in Germany and Italy, a highly centralized institution of control exists. In the U. S. A., there are a number of controlling authorities, but the Board of Governors of the Federal Reserve System is pre-eminent. Supervision of national banks is vested in the Controller of Currency who is appointed by the President on the recommendation of the Secretary of the Treasury. The supervision of state banks varies widely.

We have given a very brief account of some of the forms of legislative control over the activities of commercial banks. The question naturally arises as to how far such legislation is likely to achieve the object it usually has in view. Any system of legislative control has undoubtedly its disadvantages In the first place, it may

encourage laxity on the part of bankers who may consider that their responsibilities end with the strict observance of legislative provisions. It has been aptly said that by framing legal regulations the state takes responsibility on itself and relieves the subject of it. In the second place, banking is a business which calls for the use of delicate judgement and great discretion It cannot be reduced to uniform principles or rules which alone legislation can ensure. It also involves carrying of risk the proper assessment of which cannot be provided by law. In the third place, legislation like the deposit insurance scheme may induce weak institutions to undertake risk they should not. Such legislation may put a premium on the pursuit of evil practices by unsound banks and operate in practice against the interest of good banks. Lastly, there can be no truer saying than that good banking is assured, not by good laws, but by good bankers The whole case in respect of bank regulation by legislation has been very well summed up by Allen in the following words[1] : 'An honest and competent management cannot be attained by legal enactment, but rather by proper methods of recruitment and training, proper remuneration and conditions of work and a system which gives wide scope and high prospects to the talented. It is here that the British banks have succeeded while those of certain other countries have failed. So, too, an honest and efficient internal inspection system obviates the need for government examinations. It is believed that even in countries where legal regulation is most detailed, the ultimate success and efficiency of the banking system will be due more to the growth of such traditions in the banks themselves than to external control. Past experience has

[1] op. cit., p 49.

made this evident for it has frequently happened that under the same banking law one of two banks has failed, while the other has emerged intact from the same crisis.'

BANKING LEGISLATION IN INDIA

Until 1936, joint-stock banks in India were governed by the general provisions of the Indian Companies Act. A departure was, however, made in 1936. Although banks were subject to no separate statute, part X-A of the Indian Companies (Amendment) Act of 1936 was devoted exclusively to banks. The Reserve Bank of India was, however, giving serious thought to the question of banking legislation. In fact, it prepared a Draft Bank Bill and submitted it along with a memorandum to the Government of India in 1939. The outbreak of the war postponed the consideration of the Bill. In 1944, Sir Jeremy Raisman introduced before the Central Legislative Assembly a Banking Companies Bill based primarily on the recommendations of the Reserve Bank of India as incorporated in the Draft Bank Bill. This Bill was subsequently circulated for eliciting public opinion through the Provincial Governments. Subsequently, it was referred to a Select Committee which was due to meet in October 1945, but it lapsed before its consideration by the Committee. The present Bill, which Sir Archibald Rowlands introduced before the Central Assembly in February 1946, is based on the measure introduced in 1944, with certain modifications.

The statement of objects and reasons appended to the Bill enumerates its main features as follows:

(*i*) a simple definition of banking with the object of limiting the scope of legislation to institutions in which the funds are deposited pri-

marily to ensure their safety and ready withdrawability ;

(*ii*) prescription of minimum standards ;

(*iii*) prohibition of trading with a view to eliminating non-banking risks ;

(*iv*) inclusion in the scope of the legislation of banks incorporated or registered outside British India ;

(*v*) introduction of a comprehensive system of licensing of banks ;

(*vi*) provisions for an expeditious procedure of liquidation ;

(*vii*) inspection of the books and accounts of a bank by the Reserve Bank when necessary ;

(*viii*) empowering the Central Government to take action against banks conducting their affairs in a manner detrimental to the interests of the depositors ;

(*ix*) prescribing of a special form of balance-sheet and conferring of powers on the Reserve Bank to call for periodical returns.

From the point of view of practical bankers, the main features of the Banking Bill that deserve particular attention are the following :

1. *Clause* 11 *relating to the capital structure of banks.* Under the Bill, the minimum paid-up capital and reserve must be one lakh of rupees and the maximum provided under it is Rs 20 lakhs. Subject to these conditions, a bank having a branch outside its province or its principal place of business elsewhere than in British India must have a paid-up capital and reserve of not less than Rs 20 lakhs and in other cases, that is, where a bank does not operate outside the same province, the aggregate paid-up capital

and reserve must be (*i*) five lakhs if it has any office in Calcutta or Bombay plus (*ii*) two lakhs of rupees in respect of each town, other than Bombay and Calcutta, having a population of over 100,000 in which it has an office, plus (*iii*) ten thousand rupees in respect of each other town, village or similar locality in which it has an office.

Two observations are pertinent in regard to this section. First, the requirement of Rs 20 lakhs as the minimum paid-up capital and reserve for a bank having offices in two provinces will work as a serious hardship and handicap upon banks operating in areas where the boundaries of two provinces adjoin. These banks may be quite small institutions and yet have branches in contiguous business areas which may fall in more than one province. This anomalous position calls for adjustment and one solution may be to invest the Reserve Bank with authority to exempt, in its discretion, banks from complying with this requirement and lay down such alternative conditions as these banks may be required to fulfil.

Secondly, the position of many existing small banks require sympathetic consideration. While clause 11, subject to what has been stated above, may be accorded full support in respect of new banks to be established, it cannot be gainsaid that it may spell disaster to many small banks. Some of these banks may be beyond redemption and no sympathy need be shown to them. But there may be others which, with some concession or encouragement, may be enabled to survive to the lasting benefit of both a large number of depositors and shareholders. It would be a great pity and also extremely unwise if these banks were to completely succumb as a result of the ruthless application of Section 11. The problem of such small banks is of special interest and importance to Bengal. A suggestion

was mooted that a small advisory body consisting of Reserve Bank officials or independent Bengali bankers approved by the Reserve Bank might be set up whose primary function it would be to examine the position of small banks either on its own initiative or at the request of the small banks and suggest suitable schemes, wherever warranted, for their resuscitation. A number of such banks may well be assisted to survive by various methods, such as, an extension of the period for complying with the requirement in respect of capital structure or suitable schemes of amalgamation, etc.

2. *Liquidity Provisions.* In a broad sense, clauses 13 to 17, 19 and 20 may be grouped under this heading inasmuch as these clauses are aimed at ensuring the liquidity or safety of the assets of a banking company. Clause 13 prohibits any charge on unpaid capital. Clause 14 provides for the transfer every year out of declared profits 25 per cent of such profits to the reserve fund until this fund becomes equal to the paid-up capital. Clause 15 enjoins that all banks other than scheduled banks must maintain a cash reserve of a sum equivalent to at least 1½ per cent of its time and 5 per cent of its demand liabilities. Scheduled banks have to maintain a cash reserve of 2 per cent of their time and 5 per cent of their demand liabilities. Clause 16 restrains a banking company from forming a subsidiary company except for purposes of acting as trustee or executor or for business incidental to banking. This section also prohibits a bank from holding shares in any company whether by way of pledge or mortgage or as absolute owner of an amount exceeding 20 per cent of the issued and subscribed share capital of that company or 20 per cent of its own issued and subscribed share capital and reserves, whichever is less. Clause 17

prohibits a bank from making loans or advances on the security of its own shares or granting unsecured loans or advances to its directors or to firms or companies in which it or any of its directors is interested as partner, director or managing agent. Clause 19 requires a bank to maintain in cash, gold, or unencumbered approved securities valued at a price not exceeding current market price an amount which shall not at close of business on any day be less than 25 per cent of its total deposits in British India. Clause 20 provides that a bank must maintain at least 75 per cent of its deposits in British India.

These provisions should not prove irksome to or difficult of fulfilment by banks. It is only necessary to add that the public should not entertain any exaggerated opinion of the value of these provisions in ensuring the soundness or liquidity of banking institutions. Only clause 19 has some direct value inasmuch as it provides that a bank must maintain at least 25 per cent of its deposits in cash and unencumbered approved securities. But the stability and soundness of a bank will materially depend on how the balance of its deposits is invested

3. *Licensing of banks and their branches.*

Clause 18 provides for licensing of banks. No existing scheduled bank need take a licence except in the case of a scheduled bank which is incorporated elsewhere than in India or the U.K. and where the country in which it is incorporated discriminates in any way against banking companies in British India An existing non-scheduled bank need not take a licence for five years from the commencement of the Act. The Reserve Bank is also empowered to cancel any licence under certain specified conditions. These provisions for licensing of banks are not harsh. But sub-clause 6 of clause 18 relating to

opening of branches is of a controversial character. The power which is sought to be given to the Reserve Bank to have the final say as to whether or not a bank will be allowed to open a branch at a particular place will almost certainly occasion misgiving and resentment on the part of commercial banks.

In view of the delay in enacting the Banking Companies Bill, an Act has, however, been passed in 1946 entitled the Banking Companies (Restrictoin of Branches) Act for the purpose of restricting the indiscriminate opening and removal of branches by banking companies. Under this Act, no banking company may open or change the location of an existing branch without obtaining prior permission in writing from the Reserve Bank. Before giving this permission to any banking company, the Reserve Bank may take into consideration its financial condition or history, the general character of its management, the adequacy of its capital structure and earning prospects and the public interest to be served by the branch.

Some minor observations on certain other sections of the Bill may be made. Clause 12, for example, says that a bank shall not pay, directly or indirectly, by way of commission or remuneration or in any other form for shares sold an amount exceeding 2½ per cent of the paid-up value of the shares For facility of work and accounting, the amount should be 2½ per cent on the subscribed and not paid-up value of the shares. The intention of clause 21 requiring banks to submit a return of unclaimed deposits which have not been operated for ten years is not clear. If, as has been suggested, the Government would propose to take over these deposits themselves, it will not be fair to the banks. For, even if such amounts be regarded as in the nature of a windfall, there are cases where banks may

suffer unforeseen losses in respect of which the Government evidently do not propose to accept any responsibility. Under clause 31 the period of moratorium that can be granted by courts is limited to three months. An application for a moratorium shall be ordinarily accompanied by a report of the Reserve Bank indicating that in its opinion the bank concerned will be able to pay its debts if the application is granted Clause 32 provides for the winding up of a banking company if it should fail to meet lawful demand for payment within 2 or 4 days or on the application of the Reserve Bank which will be made if on an inspection of the affairs of the banking company it should appear to the Reserve Bank that its business is being conducted to the detriment of the interests of its depositors. There should, however, have been a further provision under which pending the disposal of the application for winding up, a bank shall not be allowed to fritter away its resources. To avoid unnecessary expense and delay in liquidation proceedings, the Reserve Bank is to be the Official Liquidator for the winding up of banking companies. Clause 39 makes all bank amalgamations subject to the approval of the Reserve Bank so as to prevent amalgamations between unsound companies.

CHAPTER XI

CLEARING

SOME machinery for the handling of 'items' such as cheques and drafts, payable by banks on each other, is essential in every developed banking system. Items payable at other banks may be dealt with in one of two ways, namely, collection or clearance. Collection involves the sending of these items to banks where they are payable, and receiving cash over the counter in exchange. Clearance, on the other hand, involves offsetting reciprocal claims against one another and settling merely such balances or differences as remain outstanding.

Clearance is usually effected through the agency of a clearing house. A clearing house ensures many advantages. These advantages may be compared to those which the clearing process of an individual bank ensures to its own clients. A clearing house prevents frequent and tedious walks by a bank's employees for the collection of cheques and drafts, the payment of the instruments in cash, and the consequent danger of loss in transit. It thus assures convenience and economy. Further, it avoids the necessity of holding by each bank of large till money with prejudicial effects on the efficiency of the banking system.

In Calcutta there are two clearing houses, one run by the Calcutta Clearing Banks' Association and the other by the Metropolitan Banking Association. The former serves only the larger banks in Calcutta, which are known as the clearing banks, and a few others which have been accepted as sub-members. The Metropolitan Banking Association owes its origin to the imperative need felt by non-clearing

banks in Calcutta to remove a crippling handicap on their business and prospects of expansion owing to the imposition of a charge by some of the clearing banks for the collection of cheques and drafts drawn upon non-clearing banks, and refusal on the part of some other clearing banks to collect them at all.

Procedure of Clearing of Calcutta Clearing House

All cheques, bills and other documents payable at the office of a member or sub-member in Calcutta may be passed through the Clearing House. It is provided, however, that dividend warrants and telegraphic transfer receipts shall be accepted only at the first clearing, and, except on Saturdays, they cannot be returned through the special clearing. A sub-member is not entitled to deliver direct any document to be cleared on its behalf through the Clearing House. Documents of a sub-member must be submitted through its sponsor member whose representative in the Clearing House will incorporate such documents in the Clearing House Register of the sponsor member.

Each member or sub-member has to provide for the use of its representative attending the Clearing House a Register suitably ruled in which a record of the documents received and delivered by him in the Clearing House will be entered.

Each member enters into a separate delivery slip a list of documents, in detail, with the total number and amount thereof. This total is entered into the Register against the particular bank. This procedure is repeated in the case of documents received against all other member banks at each of the four daily deliveries from Monday to Friday and the three on Saturday. A representative of the clearing member at the Clearing House hands over to a

representative of each drawee member the documents deliverable to him together with a delivery slip ; the representative of each drawee member thereupon enters the documents in his Register. After comparing the delivery slips with the documents received and verifying the totals, each representative totals the receipts and deliveries in his Register, strikes a balance therein, showing the net amount due to or by his principal, and hands over the Register to the supervisor of the Clearing House, who then strikes the gross balance of the whole.

PROCEDURE OF CLEARING OF METROPOLITAN CLEARING HOUSE

The Metropolitan Banking Association conducts only one clearing on every working day through its Clearing House. Each member of the Association has allotted to itself a separate counter attended to by its clerk. Cheques or other articles payable on demand drawn on member banks and received by other member or non-member banks, whether members of the Calcutta Clearing House or not, have to be presented at the Clearing House between the hours of 11-45 a.m. and 1 p.m. on ordinary business days and between 11 a.m. and 12 noon on Saturdays. Although the clearing rules say that cheques and other articles, payable on demand, drawn on member banks and presented by members of the Calcutta Clearing Banks' Association, shall on presentation be either paid in cash or returned immediately with return slips, this procedure is not actually followed as it was found in practice to be inconvenient.

The procedure actually followed is as follows: Cheques and other articles received at the Clearing House are distributed to the representatives of the banks on which they are drawn. These representatives then leave for their

respective offices with the cheques and return to the Clearing House by 2 p.m. with either cash or return slips for articles that will be returned unpaid. The clerks and durwans of the collecting banks return to the Clearing House about this time, and all payments in cash are made and received between 2 p.m. and 3 p.m .Cheques not paid are returned with return memos.

All settlements, it will be noted, are effected in cash. Another peculiarity is that balances are not as yet struck between debits and credits of even member banks. Full amounts for cheques and other articles presented are paid or received in cash, excepting, of course, those which are returned unpaid.

In addition to the two Clearing Houses mentioned above, a brief reference may be made to two other forms of clearing. The first is a novel method evolved in Calcutta and is called 'Pioneer Clearing'. It is a form of clearing which operates within the jurisdiction of the Calcutta Clearing House but carries with it no official sanction or recognition. In theory, it is nothing but a private arrangement between a member bank and a non-member bank—an arrangement which may or may not be recognized by other member banks. In practice, however, it is recognized by other member banks. The arrangement consists in an instruction printed on the cheques or drafts of a non-member bank to the effect that these instruments may be collected through a particular clearing bank, and in other banks agreeing to follow this instruction.

The other form of clearing is the ancient one, known as 'Walks Clearing'. Instruments received for collection are sorted out under the head of different paying banks. Messengers are then sent round to present the instruments to the paying banks and obtain cash in return.

CHAPTER XII

THE MONEY MARKET

Definition

A MONEY market is a market for the lending and borrowing of short-term funds. It is also a mechanism through which a large part of the financial transactions of a country is cleared. The term 'money market' may be used in two senses. In a broad sense, it includes all transactions for financing business of all types. In a narrow sense, it includes only short period financial transactions. When we speak of the money market, we refer to it in this narrow sense. It is a reservoir of short-term funds, and is concerned with the buying and selling of temporarily surplus funds.

The money market should be distinguished from what is described as the capital market. In practice, the two markets are often inter-related ; for, transactions originating in one market may be completed in the other. Thus, the payment of interest or dividend has its origin in the capital market but may exercise its influence on the money market in the same way as the repayment of commercial paper does. Notwithstanding this close relationship between the capital and the money markets, they fulfil different purposes. The money market is concerned with short-term funds used mainly for financing current business operations or short-period requirements of the government while the capital market deals with long-term funds required by industry or government. In addition to the difference between the two markets in respect of time, there is also a difference of institutional control. Thus, in most countries, a special set

of institutions deals in long term funds. Whether they are called investment bankers, money-lenders, brokers, mortgage bankers or by any other name, they constitute the various elements that go to make up the capital market in a country. A different set of institutions or agencies deals in short-period funds.

NATURE OF THE MONEY MARKET

A money market should be distinguished from, say, a commodity market. It is neither so simple nor so highly organized as a commodity market is. A money market is indefinite in two ways. Firstly, it is unorganized in the sense that there is no formal trading place, purchases and sales being effected wherever a buyer and a seller come together and reach an agreement. Secondly, there is a more or less constant flux in the personnel of the market except for a few institutions which specialize in short-term funds such as brokers and agents. A money market has therefore been described as 'a loosely organized affair with a number of divisions and sub-divisions, each devoted to a particular type of credit operation and each constituting a separate market in itself. Each division of the market, however, is closely related to the others, and conditions in one affect the others'.

COMPOSITION OF THE MONEY MARKET

In a broad sense, say Madden and Nadler,[1] a money market embraces a number of independently organized markets, which are directly or indirectly related to the capital market proper. In this broad sense, a money market may comprise the following individual markets: (*a*) the money market proper; (*b*) the capital market; (*c*) the com-

1 *The International Money Markets*, p. 109.

modities market ; (*d*) the foreign exchange market ; (*e*) the bullion market, especially in London ; and, to a lesser degree, (*f*) the shipping market, and (*g*) the insurance market.

Although the money market proper may thus be differentiated from the other markets, the close inter-relation between them should be borne in mind. The other markets support in various ways the money market proper. In these other markets are effected many business transactions which the money market finances, and without which a money market may not even be necessary.

The money market proper, which deals in short-term funds and with which we are primarily concerned, may again be divided into different sections. These subdivisions may vary in their content and importance from country to country. The main constituents of the London money market, for example, are : (*a*) the discount market , (*b*) the acceptance market ; (*c*) the short-term government securities market ; (*d*) the carry-over or contango market, that is, the extent to which operations of stock-brokers are financed by short-term loans from the money market. In New York, the main constituents of the money market are : (*a*) the commercial paper market ; (*b*) the acceptance market ; (*c*) the collateral loan market ; particularly the broker's loan market ; (*d*) the short-term government security market. In India, the money market proper has neither the significance nor the importance it has in London and New York. Its main constituents are · (*a*) the call money market ; (*b*) the short-term government security market ; (*c*) the broker's loan market and (*d*) the bill market. The bill market in Calcutta or Bombay is undeveloped, and the other sectional markets also are not very important. Without the inclusion of the collateral loan market, the operations

of which cannot always be included within the strict meaning of the short-term money market, the Bombay or the Calcutta money market loses much if its significance for the volume of operations in the other sectional markets is comparatively much smaller.

Requisites of a Money Market

The principal requisite of a money market on the supply side is that there should be a large volume of temporarily surplus funds. This is so because the funds may be recalled at any time. For example, if commercial banks have lent out money, they may have to recall it should depositors present them with a sudden demand for withdrawal of funds. The lender in the money market cannot therefore tie up his funds for a long period. Even though in actual fact he may not need these funds for a long time, he has always to be prepared for their sudden withdrawal. This necessity for quick availability of funds lent out in the money market can be met only if the total supply in the market is large. This consideration is not affected by the type of obligations in which funds are invested for even if they are first class bills or short-term government paper, it may be necessary at times merely to shift these loans, not liquidate them. For example, if a loan is given against the security of government paper to a stockbroker and it is recalled by the lender, the broker does not usually sell his security. What he does is to obtain a loan from a third party and pay off the original lender. The particular loan or debt still remains outstanding in the market, but is only shifted from one person to another. Such shifting of credit is facilitated by a large supply of funds in the money market. If the amount withdrawn from the market at any time is not large compared with the total available supply of funds, no effect

of liquid papers, the better is it for the money market. For the market will then be in a position to absorb without difficulty the ebb and flow of funds.

Institutional Organization of the Money Market

The money market may be analysed on the basis of the different institutions engaged in lending and borrowing short-term funds. The nature of these institutions may differ from country to country. Further, the same institution may appear both as a borrower and a lender in the market. Nevertheless the following classification indicates the principal lenders and borrowers in the market. Among lenders may be mentioned:

1. *The Central Bank.*—It is the ultimate reservoir of funds and the lender of the last resort. In England and America, it deals, directly or indirectly, with banks only. On the continent, particularly in France and Belgium, the Central Bank probably deals more with the public than with banks. In America member banks borrow directly from the Federal Reserve Banks, while in England, joint-stock banks do not approach the Bank of England directly, and the latter's influence on the money market is exercised through bill brokers and discount houses.
2. *Commercial Banks.*—They are the most important class of lenders in the market. They also figure at times as borrowers from the Central Bank, directly or indirectly. Most of the funds they lend to the market are received from depositors, and the major portion of these

funds is withdrawable on demand. We have seen that these funds are invested in various forms of assets. But it is in assets, which constitute what is called a banker's secondary reserve, that the money market is interested. The outlet for short-term funds differs in different countries. In England, these funds are mainly loaned to bill brokers and discount houses or invested in the purchase of acceptances and Treasury Bills. In the U. S. A., these funds are loaned to the acceptance, commercial paper and brokers' loan markets. On the Continent, short-term funds are utilized in financing stock-market transactions and purchasing two-name trade bills, which upon endorsement by banks become eligible for discount at the central bank.

3. *Institutional investors*, such as savings banks, insurance companies, trust companies and investment trusts These institutions differ from commercial banks in that their funds are generally not withdrawable on demand, yet they consider it necessary to maintain some portion of their funds invested in liquid assets. This amount finds its way into the money market.

4. *Private individuals, partnerships and corporations.*—Under ordinary circumstances, this group does not find investment in the money market profitable on account of low interest rates prevailing there. If, for certain reasons, interest rates in the money market rise and become attractive, this group may divert some portion of their surplus funds to the money

market. This happened during the Wall Street boom of 1928-29.

The borrowers in the money market must naturally be limited in number for they have to satisfy certain stringent conditions in the paper which lenders in the money market will accept. For example, the paper must be absolutely liquid, easily realizable and of short maturity. In London, these conditions are fulfilled by such borrowers as bill brokers, discount houses and dealers in acceptances and Treasury Bills. In New York, the principal borrowers are stock brokers and security and acceptance dealers. In the leading financial centres on the Continent, security dealers and the smaller financial institutions are the chief borrowers in the money market.

Central Banks and the Money Market

Every money market is to a larger or smaller extent subject to the control of the central bank. The nature and method of this control may vary from country to country and has been explained in Chapter IX.

Services of the Money Market

A money market occupies a very prominent position in and renders many useful services to the national economy of a country. It is a mechanism through which surplus funds are pooled together. It offers the commercial banks and other financial institutions the means of temporarily employing their surplus funds in easily realizable assets, and also constitutes a reservoir from which funds may be obtained in times of special need. Its services to a nation are comparable to those of a bank to a locality. The money market renders signal service to the government. It enables the government to obtain short-period funds to tide over tem-

porary difficulties. In its absence, the government would have been obliged to obtain funds either by borrowing from the central bank or by issue of currency notes. Both these processes would have had inflationary consequences, and would thus be harmful to the national economic interest. In a good money market even foreign governments may secure short-term funds for meeting their temporary needs. Lastly, the inter-relationship between the money and the capital markets may be emphasized. The existence of a good money market often facilitates operations in the capital market. The money market sometimes helps the carrying of long-term securities for short periods before they are absorbed by the capital market. Further, conditions in the money market and the rates of interest obtaining there have an important bearing on conditions and interest rates in the capital market.

PART II

FOREIGN MONETARY SYSTEMS

CHAPTER XIII

THE MONETARY SYSTEM OF GREAT BRITAIN

THE monetary system of a country comprises all banks including the central bank, and other credit institutions which exist therein for the purpose mainly of dealing in short-term credit. In Great Britain, the component elements are the Bank of England, joint-stock banks, certain other banks, acceptance houses, discount houses and bill-brokers. We shall now examine these institutions which create or sell credit in the London market.

THE BANK OF ENGLAND

The Bank of England is the oldest central bank in the world and the nerve centre of the London, and also of the international, money market Before the first Great War, it was the mainstay of the international gold standard.

Among central banks, the Bank of England occupies a unique position. Until 1946, it was a private institution practically independent of any form of legal control except in respect of its powers of issuing bank notes and granting loans to the state. It owed its foundation in 1694 to the difficulties of the government of the day in securing subscription to State loans. In consideration of a loan of £1,200,000 to the government of William III, a group of private bankers was granted, by an act of Parliament and a Royal Charter on July 27, 1694, the right to organize a joint-stock company under the name of 'The Governor and Company of the Bank of England'. This is still the official name of the Bank of England. Subsequent extensions of

the Charter coincided with the grant of additional loans by the Bank to the government. Finally, by the Bank Act of 1844, the Bank's Charter was extended for an indefinite period subject to termination by a year's notice and the repayment of the debt amounting to £11,015,100 due to the Bank by the state.

In 1946, the Bank of England has been nationalized Its previous stock-holders have received a four-to-one allotment of Government stock to provide them with the same annual income as their holding of Bank stock had produced annually for the past twenty-two years In fact, their twelve per cent return has been guaranteed for a further twenty years and as such they have no legitimate ground for complaint.

Management

The Bank is administered by a board of directors known as the Court of the Bank of England. Until the Bank was nationalized in 1946, the Court consisted of a Governor, a Deputy-Governor and twenty-four members. In theory, the Court was appointed by the shareholders, but in practice the new directors were recommended by the Court, and its recommendation was simply confirmed by the votes of the shareholders. All were nominally elected for one year only but were entitled to be re-elected and were in fact re-elected from year to year. The offices of the Governor and the Deputy-Governor were usually given in rotation for two years, the Deputy-Governor succeeding the Governor, and the oldest director not in office becoming the Deputy-Governor. There had been deviations from this practice during the last war, while Mr Montagu Norman had been re-elected Governor from year to year from 1920 to 1944.

Under the Act nationalizing the Bank, the number of

directors—excluding the Governor and his deputy—has been reduced from twenty-four to sixteen. They are all to be appointed by the Crown. The Governor and the Deputy-Governor are to hold office for five years The directors are to be appointed for a term of four years, one-fourth retiring every year.

Operations of the Bank

Although the Bank has been nationalized, every significant feature of its former organization that is not directly inconsistent with public ownership has been preserved. What has mostly happened is that what was formerly an informal procedure has now been formalized. It is significant that the former Governor, Lord Catto, and the Deputy-Governor, Mr Cobbold, have been re-appointed for the new term of five years and that only three of the sixteen directors now appointed are new The Treasury is, of course, now empowered to give directions to the Bank, but only after consultation with it at the highest level. In actual fact, this does not constitute any marked departure from existing practice. Subject to such directions, the Bank is free to conduct its affairs according to its own assessment of what will best serve national interests. Further, the Bank will not be subject to interference by Government in its day-to-day administration.

The London 'Economist' comments as follows on the nationalization of the Bank of England: 'Nothing has happened to alter the original impression that the nationalized Bank of 1946 will not differ in any fundamental way from the privately-owned Bank of 1945—or, for that matter, of the past decade. The Court will be smaller, and its composition somewhat altered, but the staff and the prin-

cipal executives will remain the same. More information, it is hoped, will be regularly forthcoming about the policies that are being pursued and the techniques required to implement them . . . . The regular working of the Bank will continue as before. The broad strategy will be neither more nor less dominated by Government policy than in recent years, whilst the tactics will be the Bank's own affair.'

The Note Issue

One of the principal functions of the Bank of England, as a central bank, is that of note-issue. By the Bank Charter Act of 1844, the Bank was given the exclusive right to issue notes, subject to the existing note-issue privileges of the country banks. It was further provided that if, after the passage of this Act, any country bank should cease to issue notes, the Bank would be empowered to increase its fiduciary issue by two-thirds of the lapsed issue. By the Act of 1844, the amount of notes the Bank could issue against securities, that is, the fiduciary issue was rigidly fixed at £14 millions. With the final lapsation of the note-issue privilege of all country banks in 1923, the fiduciary issue of the Bank of England was raised to £19,750,000. Any further issue of notes in excess of the permissible fiduciary limit had to be covered cent per cent by gold bullion or coin. Since 1844 and until 1914, no provision existed in England for the automatic increase of note-issue either in times of exceptional stringency or to meet the demand for additional currency arising from the normal economic progress of the country. This inelasticity was remedied largely by the growth of the cheque habit and the creation of bank money. But, even so, periodic crises occurred owing to the rigid provision of the Bank Act.

Thus, serious crises which occurred in 1847, 1857 and 1866 were relieved, not by assistance of any provisions of the Act, but by their suspension, whereby the Bank was permitted to increase its fiduciary issue of notes Again, during the crisis of 1914, at the outbreak of the first Great War, the Bank Act proved a failure. The Government was prepared to suspend it again. But the emergency was met instead by the creation of a new form of money in order to satisfy the rising demand for cash. This amounted virtually to a suspension of the Bank Act. The Treasury was given authority to issue currency notes in denomination of £1 and 10*s*., leaving the amount and manner of issue to the discretion of the Treasury. These currency notes issued by the Treasury, also known as Bradburies, superseded the gold sovereign, which disappeared from circulation.

Critics of the Bank Act of 1844 pointed to these difficulties as a justification of their contention that the provisions of the Bank Act were extremely rigid and unsuited to modern requirements. Although during the difficult years between 1914 and 1928 the position was modified by the issue of Treasury notes, critics pointed out that it confirmed their argument about the inadequacy of the Bank Act as the basis of the country's credit system. It was also suggested that the inelasticity of the British currency system was partly responsible for the prolonged post-war depression in Britain, while the more elastic system of the U.S A., it was contended, had made possible the expansion of credit to keep pace with business requirements.

In 1918, the Cunliffe Committee inquired into the conditions of currency and foreign exchanges after the War. It generally supported the underlying principles of the Peel Act of 1844, but conceded that modern conditions demanded

a greater degree of elasticity in the currency mechanism. The main recommendations of the Cunliffe Committee were. (*a*) the absorption of the Treasury currency by the Bank of England; (*b*) adherence to the principle of a legally fixed fiduciary issue as stipulated in the Bank Act of 1844; (*c*) the retention of the elasticity provision of the Currency and Bank Notes Act of 1914, which permitted the Bank of England, with the consent of the Treasury, to issue notes temporarily in excess of the fiduciary limit; and (*d*) a return to the gold standard as soon as the Bank of England could successfully maintain a stock of gold not less than £150 millions.

The recommendations of the Cunliffe Committee were generally accepted and embodied in two Acts. By the Gold Standard Act of 1925, the gold bullion standard was introduced, and the Bank was obliged to sell gold in quantities of 400 ounces or more at £3. 17*s*. 10*d*. per standard ounce and buy gold at £3. 17*s*. 9*d*. per ounce. The Gold Standard Act abolished the free coinage of gold.

Currency and Bank Notes Act, 1928.—The other Act, which was enacted following the report of the Committee on the Currency and Bank of England Note Issues, 1925, was the Currency and Bank Notes Act, 1928. This Act amalgamated the two types of notes in circulation, the Bank of England and the Treasury notes, and fixed the fiduciary issue at £260 millions. This figure represented approximately the combined amount of the maximum fiduciary issue of the Bank of England and the Treasury notes for 1927. All currency notes outstanding on November 22, 1928 were transferred to the Bank, which was also authorized to issue £1 and 10*s*. notes. The Act also provided that the fiduciary issue of £260 millions might include silver coin to an amount not exceeding £5½ millions. In

the second place, the Act made provision to assure some degree of elasticity in the note issue Thus, authority was given to the Treasury to permit a reduction or increase of the fiduciary issue. The Treasury minute authorizing such issue must be laid before both Houses of Parliament. Any authority so given is applicable for a period not exceeding six months, but it may thereafter be renewed for a further period of six months, provided that no expansion or contraction of the fiduciary circulation shall exist for more than two years without express Parliamentary sanction.

The Currency and Bank Notes Act, 1939.—The Currency and Bank Notes Act, 1939 which came into force from March of that year has brought about a noteworthy change in the note-issuing system of Great Britain. The essence of the change is that in future the assets backing the Bank of England note circulation—gold and securities—are to be revalued each week at market prices and that any discrepancy between the resulting figure and the amount of notes outstanding is to be remedied not, as hitherto, by adjusting the issue to the backing, but by exactly the reverse process, namely, diminishing or increasing that backing, as the case may be, through transfers of gold or securities to or from the Exchange Equalization Account. Thus it is the outstanding volume of notes issued which becomes the determinant factor in the position of the Issue Department of the Bank of England. The note-issue is no longer to be determined automatically by changes in the volume of the gold reserve.

The main provisions of the new Act are those relating to the revaluation of the assets in the Issue Department and to the consequent adjustment of the fiduciary issue. The revaluation is to take place on the basis of market prices

certified by the Bank of England. The first revaluation under the Act took place immediately after it received Royal assent. The initial operation, on the basis of the gold price then prevailing, raised the gold reserve in the Issue Department from £126 millions to £221 millions. In order to neutralize this surplus of £95 millions the fiduciary circulation was reduced from the figure of £400 millions to £300 millions which in future will be the 'normal' fiduciary issue, replacing the figure £260 millions provided for under the Currency and Bank Notes Act of 1928. The new measure maintains the existing provisions for varying the fiduciary issue by Treasury minutes The immediate net effect of the gold revaluation and of the reduction in the fiduciary issue would thus have been to cancel some £5 millions of notes and correspondingly to reduce the reserve in the Banking Department. But to maintain the note issue at its former level, and in consequence to prevent a sudden contraction in the Reserve, the Bank of England bought some £5 millions gold from the Exchange Equalization Account. The new Act provides specially for such operations, stating that any gold bought or sold between the Issue Department and the Account is to be priced at the last weekly valuation of the Department's gold holding. Thus the authorities will have complete freedom to vary the amount of notes in issue by shifting gold to and from the Issue Department as well as by changing the fiduciary issue. There would thus be greater freedom of action.

It should be emphasized that the new Act does not in any way prejudge the question of ultimate stabilization. Further, it neither imposes any new restrictions on the issue of notes nor removes any restrictions that are now in existence. It is true that the authorities have very large powers to alter the note-issue, since they can buy and sell gold between

the Account and the Department without recourse to the market and can alter the fiduciary issue, at least temporarily, by order. But these powers are not conferred upon them by the present Act. The first is implicit in the Finance Act of 1932, which set up the Exchange Equalization Account, and the second was conferred by the Currency and Bank Notes Act of 1928. Between them, these powers create a very elastic system of note-issue ; but the present Act neither adds to its elasticity nor subtracts from it.

The new Act, however, is the first explicit recognition of the principle that it is the size of the note-issue that determines the size of the reserve, and not *vice versa.* This principle is explicit in the short run in the provision for week-by-week adjustment of the reserve and it is implicit in the long run too, for there is no doubt that if the public were to demand more notes than the total fixed under the Act, gold would be sold to the Department or the fiduciary issue raised.

The Two Departments

By the Bank Act of 1844, the Bank of England had been divided into two separate departments, one for the issuing of notes and the other for ordinary banking business. This division was also useful in the allocation of the profits of the Bank. For the profits of the Issue Department went to Government, while the profits of the Banking Department were available for distribution to shareholders. Now that the bank has been nationalized, all profits will accrue to the Government.

The activities of the Bank in both its Issue and Banking departments are revealed, as before, in its weekly return. The following is the Bank of England Return for the week ended September 3, 1947.

ISSUE DEPARTMENT

NOTES ISSUED :	£		£
In Circulation .	1392,412,870	Government Debt	11,015,100
		Other Government Securities ...	1438,340,690
In Banking Department ...	57,834,963	Other Securities ...	635,499
		Coin other than Gold	8,711
		Amount of Fiduciary Issue	1450,000,000
		Gold Coin and Bullion ... (at 172s 3d. per oz fine)	247,833
	1450,247,833		1450,247,833

BANKING DEPARTMENT

	£		£
Capital ...	14,553,000	Govt Securities ...	319,367,350
Rest	3,924,926	Other Securities .	
Public Deposits ..	12,485,469	Discounts & Advances	19,886,185
		Securities	17,909,058
Other Deposits			
Bankers ..	292,304,491		37,795,243
Other Accounts ..	94,267,270		
		Notes ...	57,834,963
		Coin	2,537,600
	417,535,156		417,535,156

Issue Department

Liabilities.—Notes issued represent the entire liability of the Bank. Notes in circulation consist of notes in the hands of the public and in the vaults of banks. Notes held in the Banking Department are not in circulation, and represent the difference between the total notes issued and the notes in circulation.

Assets.—The assets held as cover against notes are divided into (*a*) the fiduciary portion and (*b*) gold. The fiduciary issue is backed chiefly by government securities

and silver coin which must not exceed £5½ millions. *Government debt* represents the loans made by the Bank directly to the government. *Other government securities* consist of government bonds, Treasury Bills, etc., while *other securities* include commercial bills, bonds, stock and foreign exchange. *Gold coin* and *bullion* represent the monetary stock of gold of the Bank.

BANKING DEPARTMENT

LIABILITIES

Capital.—Like the Government Debt, this also has been unchanged since 1833. Until 1946, it was represented by fully-paid stock issued to the public which earned about 12 per cent on the nominal amount. Now, the capital has been taken over by the Government.

The Rest is a general reserve of the Bank, representing the accumulation of undivided profits, and the balance of the Profit and Loss Account. It has not been allowed to fall below £3,000,000, and its gradual increase during the year gives an indication of the profit likely to be made by the Bank

Public Deposits represent the sums standing to the credit of the Government Departments. They vary with the collection of income-tax, payment of dividends on Government stock, etc., while an important influence upon them is the incidence of Treasury Bill payments and maturities.

Other Deposits are the deposits of the Bank's other customers, including the balance of the other banks whose business is primarily domestic in character, shown separately as 'Bankers' Accounts'.

Movements in the item 'Bankers' Accounts' afford a fair indication of the disposable funds of the money market,

and of the trend of financial affairs. Usually, Public Deposits and Bankers' Accounts vary inversely. Amounts paid by the Government as interest and dividend out of the former help to swell the latter, whereas Bankers' Accounts are decreased and Public Deposits swollen when income-tax payments begin to flow in. The relation between these two items was very marked on the issue of War Loans, for these added enormous amounts to Public Deposits at the expense of the balance of the other banks. At times, however, the relation has been obscured by heavy borrowings on the part of the Government from the Bank, causing public deposits and government securities to increase together.

In general, a high level of Bankers' Accounts indicates that the banks have a large surplus of unemployed funds, and is usually coincident with low interest rates and cheap money. If a monetary crisis or a disturbance of credit is impending, Bankers' Accounts may rise suddenly at the same time as the Bank rate; the rise in the Bankers' Accounts indicates that bankers are strengthening their position by calling in loans or realizing securities, whilst the rise in the Bank rate indicates that the Bank finds it necessary to raise the rate of interest in order to protect its Reserve, check borrowing and restrict credit.

ASSETS[1]

Government Securities represent the extent of the Bank's investments in British Government stocks and Exchequer and Treasury Bills. They include also loans to the Government on 'Ways and Means Advances' and 'Deficiency Bill', a mode of borrowing money originally used to finance

[1] See E. Thomas: *Banking and Exchange*, pp 143-45.

Government expenditure until the tax payments came in, and much resorted to during and after the War to tide over temporary shortage.

Other securities include the investments of the Bank in securities other than those under the first heading, and also advances to bill brokers and its customers other than the State.

Other Securities are sub-divided into *Discounts and Advances* and *Securities*, and the sub-division makes it possible to form a clearer idea of market indebtedness. *Discounts and Advances* are increased when the market borrows from the Bank, that is, when loans are taken or when bills are discounted on the market's initiative. On the other hand, when the Bank buys bills on its own initiative as part of its open market policy, the increase appears in *Securities*—in 'Government Securities' when it consists of Treasury Bills and in 'Other Securities' when it comprises commercial bills.

A rise in Bankers' Accounts coincident with a rise in Discounts and Advances is generally evidence that bankers are strengthening their position. This drives market borrowers to the Bank for accommodation (in which event the market is said to be 'in the Bank'), thus causing an increase in Discounts and Advances to coincide with an increase in Bankers' Accounts through the accumulation of funds in the hands of the banks.

Reserve.—The last two items on the assets side, namely, notes and gold and silver coin, constitute what is known as the Bank's Reserve. The Reserve is the basis for the expansion of credit by the Bank, and, under normal conditions, it is the key to the Bank rate. The amount of notes held in the Banking Department is the stock which banks can use for meeting their cash withdrawals. It also re-

presents the amount of gold which the Bank can lose without any reduction in notes in circulation or expansion of the fiduciary issue In normal times the position of the Reserve affords an indication of the discount and open market policy to be pursued by the Bank.

Since the abandonment of the gold standard, and also under abnormal conditions, the Reserve has ceased to be a determining factor in discount policy. Thus in December 1932, when the British Government paid its War Debt Annuity to the U S.A , the Reserve sharply declined but the discount rate remained unchanged at 2 per cent.

The ratio of the Bank's Reserve to its deposit liabilities is known as the 'proportion' It may be compared to the cash ratio of a commercial bank. Since, however, the whole credit system of the country depends upon the liquidity of the Bank, this 'proportion' is considerably higher than the customary commercial bank's ratio. It is not prescribed by law But before 1914, it was maintained at from 45 to 55 per cent. From 1914 to 1927 the average proportion ranged from 14 to 34 per cent. Since 1927 it has again increased. In the returns quoted above the proportion stands at about 39 per cent.

The Bank of England Act and Commercial Banking: Certain powers given to the Bank for issuing directions to commercial banks are detailed in Clause 4(3) of the Act, which is the most controversial provision of the Act. The text of the clause is as follows:

4.(3) The Bank, if they think it necessary in the public interest, may request information from and make recommendations to bankers, and may, if so authorized by the Treasury, issue directions for the purpose of securing that effect is given to any such request or recommendation:

Provided that:

(*a*) no such request or recommendation shall be made with respect to the affairs of any particular customer of a banker ; and

(*b*) before authorizing the issue of any such directions the Treasury shall give the banker concerned, or such persons as appear to them to represent him, an opportunity of making representations with respect thereto.

How far the powers now given to the Bank will involve, if at all, any undue interference in the normal administration of commercial banks only the future will reveal. These powers are, however, subject to certain limitations. In the first place, such directions as may be issued to commercial banks, although they have to be authorized by the Treasury, must proceed from the initiative of the Bank, whether the object is to secure information or make recommendations. Secondly, such directions cannot be used to victimize any particular customer of a commercial bank or to compel disclosure of his circumstances Thirdly, before the direction is issued, the banker concerned will have a right to prior consultation and discuss the matter beforehand with the Treasury. Implicit in this provision for prior consultation is the right of the banker to ventilate the whole matter in public, except where the Treasury would certify that the matter is one to which the 'Official Secrets Act' would apply.

The discussion in Parliament over this clause of the Bill did not produce any clear or definite idea as to the way in which the powers envisaged under it might be used. That the possibility of influencing the distribution of credit both positively and negatively was not ruled out will be borne out by the following explanation offered in course of the Parliamentary discussion : 'it may be desirable, in certain

circumstances, to urge the banks to devote their resources to one or other form of investment, which it was felt by the Government and by the Bank of England was necessary in the interests of a planned priority, with a view to securing full employment in the country and building up our export trade and other necessary elements in our economy.'

II.—The Joint-stock Banks

The joint-stock banks sometimes also referred to as deposit or commercial banks, are, next to the Bank of England, the most important constituent of the London money market. These are the banks with which the public in general deals. They receive deposits from the public and are the chief lenders to trade and industry, the financial market and other borrowers. The establishment of joint-stock banks in London dates from 1833. As the advantages of joint-stock banking and the greater stability it offered to customers as compared with private banking were realized, there set in an amalgamation movement which has continued till recent times. In 1890, there were in England 104 joint-stock banks operating with 2,203 branches, while at the end of 1913 the number of banks was 43 with 5,797 branches. After 1917, there was a tendency for amalgamation to take place between the big joint-stock banks. Public opinion was disturbed at the prospect of further concentration culminating in a 'money trust'. A Committee was set up by the Treasury in 1918 to inquire into the dangers of the amalgamation movement. The committee recommended the adoption of legislation with regard to the submission of any proposal for further amalgamation for the approval of the Treasury and the Board of Trade. A Bill was drawn up for the purpose but it was withdrawn before it became law in

view of an understanding arrived at between the banks and the government to the effect that no further arrangements for amalgamation would be entered into without the consent of the Treasury. The number of banks has, however, declined since the end of the first Great War. Since 1928, the number has remained stationary at sixteen.

Of the joint-stock banks, the five biggest banks popularly known as the 'Big Five', control by far the largest banking resources of Great Britain. They are responsible for about 80 per cent of the bank deposits in England and Wales.

The five biggest banks are the Midland, Barclays, Lloyds, Westminster and the National Provincial. These along with six others are the London clearing banks, for they are the only members of the London Clearing House. The policy of an English commercial bank, it has been said, is a compromise between three conflicting aims, namely, profitability, security and liquidity.

The deposits the commercial banks receive are of two kinds, balances on current account and balances on deposit account; the latter cannot usually be withdrawn on less than seven days' notice. The assets are distributed after providing for cash over a variety of forms so as to secure two main objects, firstly liquidity and secondly profit. The distribution of assets of commercial banks has undergone material changes since the last War, as the following figures of the proportion of London clearing banks' assets to their deposit liabilities in 1938 and 1945 respectively will reveal:

	1938	1945
Cash on hand and balances at Bank of England	10 per cent	9 per cent
Balances with other banks and items in process of collection ..	3 ,,	3 ,,
Money at call and short notice ..	6 ,,	5 ,,
Bills discounted ...	10 ,,	8 ,,
Treasury Deposit Receipts	nil	33 ,,
Investments ..	27 ,,	25 ,,
Loans and Advances ...	44 ,,	17 ,,

In 1938, 44 per cent of the resources of commercial banks were employed in advances to industry and private borrowers ; in 1945, this dwindled to 17 per cent only. In the second place, the two main earning assets, loans and advances and investments, represented 71 per cent of the total before the War ; they now provide only 45 per cent. In the third place, the average return on investments has declined while management expenses have been rising. The fact, in the fourth place, that bank profits have nevertheless continued to grow is due to the circumstance that while bank deposits have more than doubled, capital has remained stationary.

III.—Other Banks

Banks other than the British joint-stock banks may be grouped into four main classes :

(*a*) *Private Banks.*—These banks very much dwindled in importance since the development of joint-stock banking. Most of the private banks that existed were either liquidated or absorbed

by joint-stock banks. These banks not only undertake ordinary commercial banking business, but also frequently underwrite domestic and foreign capital issues.

(b) *Colonial and Dominion Banks.*—This group consists of those Imperial Banks whose head offices are in London and whose activities are centred in some part of the Empire, and of those dominion and colonial banks which have opened offices in London. These banks finance foreign trade, and act as financial and fiscal agents for loans raised by their respective countries in the London money market. These banks are an important constituent of the London market, for they not only originate bills of exchange but also figure as buyers of bills and thus contribute to the international character of the market.

(c) *Anglo-Foreign Banks.*—These banks are formed in London under British law to facilitate international business, generally with a given country. They may again be subdivided into two further groups: the Anglo-South American banks and others. The Anglo-South American banks carry out operations similar to those undertaken by banks of the British Empire. The second sub-group consists of banks of very different types established since the first Great War, important among which are the British Overseas Bank Ltd., the Anglo-International Bank Ltd., the Anglo-French Banking Corporation, the Imperial Bank of Iran and the London and Eastern Trade Bank.

(*d*) *Foreign Banks.*—This group includes all banks with head offices outside the Empire and having their offices in London and those banks which have been constituted under English laws but are controlled by foreign shareholders. No restrictions are imposed in England on foreign banks either in respect of establishing branches or their activities, nor are they subject to any special taxation. Like banks in the second group, branches of foreign banks supply bills of exchange to the market, transact foreign exchange business, and place their surplus funds in the short-term market. They bring a substantial business to London because a large portion of the foreign trade of their respective countries is financed through them.

IV.—Acceptance Houses

The acceptance houses are essentially merchant bankers. In their origin, they were merchant traders of international repute, and their acceptance business developed subsequently out of their business as pure merchants. Sir Robert Kindersley tendering evidence before the Macmillan Committee said, 'Practically every acceptance house of old standing in this country commenced purely as merchants trading with foreign countries and a great many of them, most of them, I think, are of foreign origin. Today a great majority of them are of English nationality and have merged their personalities in the country.' In view of their business association with various countries, these wealthy merchant traders were in a position to obtain reliable credit information about other traders in those countries, and were

thus willing for a commission to lend their names to, or accept, the bills of the smaller merchants. Finding this business profitable, these merchant traders gradually gave up their activities as merchants and developed more and more as acceptors of bills.

The principal function of acceptance houses is, of course, accepting bills of exchange, thereby guaranteeing that the bills will be paid on maturity Although they do not confine their activities to any particular country or commodity, yet each house specializes in respect of the trade in a certain commodity and with some particular country.

The international reputation of the London accepting houses combined with the exceptional discount facilities available in London and the maintenance of the free gold market, led to the use of the sterling bill for international transactions all over the world, and not merely for transactions in which England is concerned either as importer or exporter, for bills always tend to be discounted in which they are accepted. In view of the profitability of acceptance business, joint-stock banks have been actively competing for this work, which formerly was confined almost entirely to the accepting houses.

Acceptance business suffered considerably during the few years prior to the outbreak of the last war. The growth of economic nationalism resulting in a dwindling of international trade, imposition of foreign exchange restrictions in many countries and a standstill in international capital movement, adversely affected the business of accepting houses. Some of the accepting houses have, therefore, tried to develop new lines of business, such as banking proper or under-writing of new issues, but not always with success. It has also been suggested that, if the international trade bill should seriously fall off, the accepting

houses should devote greater attention to developing the domestic trade bill The accepting houses depend for their prosperity upon the financing of international trade through the London market. If a policy of economic nationalism should become supreme, the accepting houses will either gradually disappear or will have to develop new lines of activity.

V.—Discount Houses and Bill-Brokers

The organization of the discount market is the most characteristic feature of the London money market. London as a money market is unique in having a group of individuals and firms, whose sole business is to discount bills of exchange. No other money market possesses such highly developed facilities for both borrowing and lending on the security of bills. In describing the unique character of the London discount market Truptil[1] says, 'The London discount market is the most remarkable feature of the City, and is an institution which has no equivalent in any other financial centre It forms a sort of reservoir whose waterline registers the ebb and flow of monetary currents. The circle of houses which specialize in the practice of discounting constitutes a market wherein the offers of and demands for bills are adjusted against the offers and demands for money on day-to-day or short notice. They are the intermediaries through which the two markets, the *money market* and the *discount market* can communicate and complement each other'.

The bill brokers are essentially intermediaries and act as a buffer between joint-stock banks and the Bank of England. They borrow money from the short-term market and

[1] *British Banks and the London Money Market*, p. 110.

employ the funds in discounting bills at a higher rate ; the difference between the two rates constitutes their profit. The bills are domestic trade bills, international trade bills and Treasury Bills. They mature in between one and six months, the majority maturing in three months.

The discount market consists of (*a*) discount houses ; (*b*) private firms, and (*c*) running brokers.

Of discount houses, there are three big public and four private companies. The three large public discount houses are Alexander's Discount Co., Ltd., the National Discount Co., Ltd., and the Union Discount Co., of London, Ltd. The resources of these companies consist partly of their own capital but mostly of the deposits they receive from the public. They allow on their deposits a rate of interest slightly higher than that paid by joint-stock banks. In case of need, they may also borrow from the market for a day or for a week. The discount houses do not invest all their funds in bills. They retain a small reserve of cash in hand and in the bank, and a larger amount of short-dated gilt-edged securities. The greater part of the bills bought by these companies are for the purpose of holding, but some are retailed to banks.

The second group of firms consists of seventeen private firms of bill-brokers which buy and sell bills on their own account. They discount bills mainly with the object of selling them again to banks at a rate of discount slightly lower than that at which they themselves have discounted the bills. They transact their business mostly with borrowed capital, and thus appear in the market as borrowers of short-term money and dealers in bills. These bill-brokers and the discount houses are in fact the chief users of money at call and short notice which is an important item in all bank balance-sheets.

There are, in the third place, a few running brokers in the discount market. They operate only as intermediaries between the buyers and the sellers of bills, and never act on their own account. They work on commission basis and need very little capital of their own. They have an intimate knowledge of the makers as well as of the buyers of bills, and are thus useful members of the money market.

The Bank of England and the Money Market

We have already explained in chapter IX how the Bank of England controls credit. This control, it may be emphasized, works out through the machinery of the discount market. Whenever joint-stock banks want to replenish their cash, they usually call in some part of these loans to the discount market If only one or two banks were to call in their loans, bill-brokers might obtain funds from other banks. But this is not possible when all the banks begin to withdraw their funds from the market. The bill-brokers are then compelled to obtain money from the Bank of England, either by obtaining an advance at usually a half per cent over the Bank rate, or by rediscounting some of their bills. At such a time the market is said to be 'in the Bank'.

It may be mentioned here that since about 1931, the staple of the short-time money market has undergone a considerable change. The trade bill has fallen off, and the bills held by the discount market are mainly Treasury Bills. As the yield on these bills is very low, bill-brokers have been obliged to increase their holding of long-dated securities.

The Exchange Equalization Account

The Exchange Equalization Account or Fund was set up to offset speculative movements in the sterling exchange.

After the abandonment of the gold standard in 1931, sterling was exposed to both ordinary and speculative fluctuation. As this was detrimental to the national interest, the Exchange Equalization Account was brought into being on June 24, 1932 In announcing the plan for establishing such an Account, the Chancellor of the Exchequer said in the House of Commons, 'It is essential for us to hold adequate reserves of gold and foreign exchanges, in order that we may meet any sudden movement of short-dated capital and check and repel the speculative movements.' In asking Parliament to authorize the establishment of the Account, he again said, 'The details of assets in the Account will not be published, but they may take various forms, either gold or sterling securities or foreign exchange. The new powers combined with the powers already possessed by the Bank—on which of course the main responsibility for the management must continue to rest—will enable us to deal far more effectively than we have done hitherto either with an unwanted inflow of capital or, if the alternative should again arise, with an outflow of capital from this country.' The Account is thus intended to smooth out temporary fluctuations, while not interfering with the real causes that affect long-term trend.

Although supposed to be a department of the Treasury, the Account is managed by the Bank of England. It began in June 1932 with assets of £150 million Treasury Bills, and added yet another £200 millions in June 1937. At the very beginning, the Account took over the Bank of England's foreign exchange holdings against payment made in Treasury Bills This operation relieved the Bank of its holding of fluctuating assets and provided the Account with considerable foreign exchange reserve. The Account also indemnifies the Bank from time to time for losses sus-

tained in repaying foreign credits, for example, losses incurred by the Bank in connexion with repayment of credits obtained from the Bank of France and the Federal Reserve Banks in 1931.

The Account works in the following manner. If it should want to offset capital inflow, that is, a demand for more sterling, it provides the extra sterling required by selling some of its Treasury Bills. It gives up sterling and acquires foreign money which is being offered against sterling. It then uses this foreign money to purchase gold. When capital tends to flow out, the Account can offset this outflow by releasing some of its gold, and getting back sterling in exchange.

The establishment of the Account has had another advantage. The Account, for example, can sell gold with a view to prevent a depreciation of the pound without disclosing the fact, for the details of its working are not published. But sales of gold by the Bank would be reflected in its weekly statement. London has thus two reserves of gold and foreign exchange: that of the Bank of England which influences domestic credit conditions, and that of the Exchange Equalization Account which fluctuates according to inflow and outflow of foreign funds without affecting domestic credit conditions.

London as an International Financial Centre

In spite of the threat of Paris and New York during a period of over a decade after the termination of the first Great War, London has continued to occupy a pre-eminent position among international money markets. There have been periods when this supremacy has been challenged by Paris and New York, but in the end London has emerged

successful. Various factors are responsible for the leadership of London in the international money markets. In the first place, London's supreme position is a direct result of the financial and economic development of Britain. It is the greatest *emtrepôt* centre in the world. It developed its industries and transport and banking services long before other nations appeared on the field. Its shipping and insurance services have world-wide ramifications and are taken advantage of by many foreign countries. Great Britain possesses some of the most important commodity markets in the world, such as Manchester for cotton, Liverpool for grain and London for metal. As the metropolis of the Empire, it occupies a very important place as the market for most of the exotic products of the world, such as rubber, ivory, tea, jute, soya, spices and shellac as well as for wool and sheep-skins. It has further the most well-developed short-term money market in the world and a world-wide insurance organization. Its acceptance and discount markets are responsible for international trade bills being generally drawn in sterling and financed through British financial institutions. Lastly, no other financial centre in the world has the experience and training of London to handle international financial transactions. All these factors have contributed not only to the attainment by London of the leadership in international finance but also to the maintenance of this position by it, in spite of the vicissitudes she suffered during about a decade following the first Great War. It remains to be seen whether in the altered circumstances which the last war brought about, London will be able to maintain its supremacy over New York.

CHAPTER XIV

THE MONETARY SYSTEM OF THE U.S.A.

THE monetary systems of the U.S.A. and Britain reveal, like their respective political constitutions, one characteristic difference. In Britain, the monetary system is the product of a slow evolutionary growth. In the U.S.A. it is essentially a creature of statutes. It may be added that in the monetary and banking systems that have been set up in various parts of the world during the last two decades or so, the American system has served as a model and has played an important role in most cases.

I.—THE FEDERAL RESERVE SYSTEM

It is a peculiarity of the American monetary system to be found nowhere else in the world that it possesses twelve central banks instead of one. These banks are known as the Federal Reserve Banks, and are the most important single factor in the American monetary system.

We may very briefly recapitulate the banking development in the U.S.A. before the passing of the Federal Reserve Act of 1913. The first type of banks established was what are known as land banks. They owed their formation to the fact that the early settlers had no asset other than land to offer. The next development in American banking is the formation of state banks, that is, banks formed under the various state laws. There were two classes of state banks, one in which the state in which the bank was formed participated, and the other consisted of banks whose capital was wholly subscribed by the public.

All these banks could issue notes, and as there was no legal obligation to maintain specie in reserve against notes, many of them came to grief. With a view to bring some uniformity into the banking and currency system of the country, the National Bank Act of 1863-64 was passed The Act brought the national currency under Federal control. National banks which were formed under charters received from the Federal government under the National Bank Act could issue notes against government bonds deposited by such banks with the Treasury. Although not full legal tender, these notes were practically accepted as such. Further, the holder of such notes had the advantage that, should the national bank issuing the notes suspend payment, the Treasury would indemnify him against any loss. The Act also made for centralization of banking. Yet the crisis of 1907 showed that, in the absence of a central banking organization, the banking system as it existed suffered from many defects. In particular, the absence of an institution which could render effective assistance to banks in emergencies was keenly felt. A National Monetary Commission was set up in 1908 to enquire into the whole question. The Federal Reserve Act of 1913 was based mainly upon the recommendations of this Commission.

The Federal Reserve Act of 1913 set up twelve Federal Reserve Banks, one for each Federal Reserve district. On the face of it, this system appears to be a decentralized one, and doubt may be expressed of the possibility of maintaining a uniform central banking policy under such conditions. Although, however, there are twelve Federal Reserve Banks, uniformity of policy has been assured by the establishment of a central co-ordinating body with the object of welding the separate Reserve Banks into a system. This body is the Board of Governors of the Federal Reserve System.

THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

As reconstructed by the Banking Act of 1935, the Board consists of seven members appointed by the President for fourteen-year terms with the advice and consent of the Senate. They receive salaries of $15,000 a year, and are not eligible for re-appointment after they have served a full term. Under the original legislation, the Secretary of the Treasury and the Comptroller of Currency were *ex-officio* members. Under the new Act, they have been made to retire, presumably with the idea of freeing the Board from official influence. Although the Governors are even now appointed by the President, their long tenure of office coupled with the fact that they are not eligible for re-appointment should assure the independence of the Board.

The Federal Reserve Board prescribes regulations governing the methods and the procedure of working of Federal Reserve Banks where uniformity appears to be necessary. Thus discount rates, although fixed by individual Reserve Banks, are subject to review and determination by the Board. This assures a harmonious credit policy on the part of the various Reserve Banks. Open market operations, which constitute the most powerful instrument of Federal Reserve credit policy, are directed by an Open Market Committee composed of seven members of the Board and five representatives of the Reserve Banks elected by the directors by geographical areas. This Committee was created by the Banking Act of 1933. The Board has further power to change the reserve requirements of member banks under certain conditions and within certain limits as well as power to prescribe margin requirements on certain types of security loans by brokers and banks. Under the Act of

dent to act as the chief executive officer of the bank for a term of five years. A first Vice-president is appointed in the same way and for the same period. Other officers are appointed by the directors, with the approval of the Board in respect of salaries to be paid.

Unlike foreign central banks, Federal Reserve Banks may engage only in those transactions and with such parties as are stipulated in the Federal Reserve Act. They have not unfettered freedom or discretion in their operations, but are subject to the supervision and guidance of the Federal Reserve Board The Reserve Banks hold the statutory reserves equivalent to a fixed percentage of the net demand and time deposits which member banks have to maintain with them. It may be mentioned that, unlike the Bank of England, the Federal Reserve Banks do not maintain two separate Departments, and their statement of affairs does not show separately the activities of the Issue and the Banking Departments.

Note Issue

There were four kinds of paper money in use in the U. S. A. before the establishment of the Federal Reserve System. They were :

1. Gold certificates, secured dollar for dollar by gold held in the U.S.A. Treasury, which could be increased or decreased only as the amount of gold in the Treasury increased or decreased.
2. Silver certificates, secured dollar for dollar by silver coin in the Treasury, the amount issued being limited by law.
3. United States notes (greenbacks of the Civil War) originally secured by nothing but the promise of the government, but subsequently covered

to the extent of about 45 per cent by gold, limited in amount by statute to \$346,700 000.

4. National bank notes, issued by national banks, secured by certain United States Government bonds carrying the circulation privilege, and limited to the amount of these bonds ; each national bank issuing notes being also required to maintain a 5 per cent redemption fund with the Treasury in Washington.

These four kinds of paper currency were interchangeable dollar for dollar, one with another, although the security behind them was not the same in each case. Further, the amount in circulation of these forms of currency was fixed in a manner that could not provide an elastic currency. This defect was rectified by the issue of another form of currency, the Federal Reserve notes, under the Federal Reserve Act. The Federal Reserve notes were designed to provide elasticity, their issue being related to business or other activity ; for the assets against which they might be issued were those of the Federal Reserve Banks. The paper used as security under the original terms of the Federal Reserve Act represented agricultural products or other goods in process of production, or in movement from producer to retailer. The paper was required to bear the endorsement of a member bank, and its maximum maturity at the time of rediscount was ninety days, except in the case of agricultural paper which might run for nine months. An amendment to the Act during the first War provided that collateral notes of member banks secured by government obligations or eligible paper might be accepted as security against Federal Reserve notes. In 1932, by the Glass-Steagall Bill, the collateral was extended to include

for a temporary period government securities purchased by the Reserve Banks.

The Federal Reserve Banks must also maintain a reserve in gold certificates of 40 per cent against Federal Reserve notes, and it may be added that they have also to maintain a reserve of 35 per cent in gold certificates or lawful money against their deposits.

Between 1933 and 1935, the United States currency has undergone important changes. In the first place, gold certificates have practically been retired from circulation. Secondly, the volume of silver certificates has been increased under the Agricultural Adjustment Act as amended by the Gold Reserve Act of 1934 and the Silver Purchase Act of 1934. Thirdly, National Bank notes have been retired with the redemption of the U. S. A. securities carrying circulation privilege. The U. S A. currency has thus been considerably simplified, and by far the most important category of notes in circulation now is the Federal Reserve.

II.—Commercial Banks

In the U.S.A., commercial banks may be chartered by both national and state governments. National banks are those organized under the National Bank Act of 1863 while state banks are subject to different state laws. The Federal Reserve Act sought to develop a more homogeneous banking structure by compelling national banks, and permitting state banks under certain conditions, to become member banks. For state banks, however, membership is only optional, and this fact constitutes an obstacle as much to developing one homogeneous banking system as to effective central banking control. The provision of the Banking Act of 1933, whereby after July 1, 1937, only member banks might have their deposits insured by the Federal Deposit

Insurance Corporation was regarded as a move to induce non-member banks to join the Reserve system. The same Act imposed drastic restrictions on commercial banks undertaking investment banking operations Formerly these banks conducted, along with commercial banking, security underwriting and distribution business. In accordance with the 1933 Act, all member banks have now either liquidated or divorced their security affiliation. Of commercial banks and trust companies which conduct commercial banking business only, those in New York are by far the most important. The degree of banking concentration in New York is, however, much less than in London or Paris.

III.—Investment Banks

Prior to 1933, these banks used to carry on considerable commercial banking business also. They accepted deposits and invested a portion of their funds in short term credit instruments and collateral loans. Since the enactment of the Banking Act of 1933, these investment banks could no longer conduct securities business and private banking business at the same time Some of the institutions, therefore, such as J. P. Morgan and Company and Drexel and Company gave up their securities business for private commercial banking, while Kuhn Loeb and Company, Speyer and Company and others relinquished their deposit business in favour of investment banking.

IV.—Accepting Institutions

There are no comparable specialized accepting houses in the U.S.A. as in Britain. The most important accepting institutions in America are the member banks. Besides them, there are a number of private banking firms, foreign banking corporations and American agencies of foreign

banks, which also engage in the business of creating acceptances. The acceptance business is largely in the hands of a few leading financial institutions located in New York.

V.—Bill Dealers

These dealers consist of a group of private bankers and other firms which act as middlemen in the money market. They usually deal in securities and acceptances, while some of them act as brokers for commercial paper and as intermediaries in the collateral loan and federal funds markets. Most of these firms are located in New York. The dealers purchase bills outright and derive their profit by selling them at a higher price. The acceptance and discount market in New York is, however, of much less significance than in London. The most important market in New York is the stockbrokers' loan market.

Federal Reserve Banks and Control of Credit

As in all other central banking systems, the ability of the Federal Reserve Banks to control credit depends upon their position as the ultimate source of cash, which is the base for building the credit superstructure. Cash in America consists of member banks' deposits with the Federal Reserve Banks and currency, of which the most important is the Federal Reserve note. Before we describe the methods by which credit is controlled in America, a reference may be made to certain noteworthy differences between the British and the American practices. In Britain, the contact between the commercial banks and the central bank is indirect and works through the discount market. In America, the member banks borrow directly from the Reserve Banks, and there is always some amount of member bank indebtedness to the Reserve Banks. One consequence of this differ-

ence is that the rate of interest in the discount market is lower than the Bank rate in London, while in New York the Bank rate is lower. Another significant difference is that commercial banks in England maintain with the central bank a balance equivalent to a certain proportion of their total deposits. The ratio that they maintain is only a customary one. In America, on the other hand, member banks have to maintain compulsorily a certain fixed proportion of their demand and time liabilities with the Reserve Banks.

METHODS OF CREDIT CONTROL

There are seven important methods of control in the field of Federal Reserve policy:

(a) *Tradition against Borrowing*.—It may appear strange to speak of tradition in America as exercising a powerful influence in the matter of credit control But it is in fact an inheritance from the past. In the past, banks which used to borrow heavily and continuously from correspondents were looked upon with suspicion. This feeling has persisted even today, and member banks which borrow large amounts and continuously from the Reserve Banks are looked upon with disfavour. Accordingly, member banks which happen to be indebted to the Reserve Bank try their utmost to reduce their debt to it, and for a reason which has directly nothing to do with the cost of borrowing from the Reserve Bank. The result is that when a number of member banks are in debt, money generally becomes tighter and rates increase. On the other hand, when most member banks are out of debt, they are in a position to

invest their funds and money rates become cheaper. As Reserve Banks have seldom charged rates higher than those asked for by member banks from their customers, it would appear that tradition is probably more important than the discount rate in preventing continuous borrowing.

(*b*) *Discount Rate.*—A change in discount rate is important principally as a public recognition by a group of competent people of a change in the credit situation. But the discount rate has not played any significant role in America as a means to controlling credit. This was due to the fact that in America from 1921 till up to the banking crisis of 1933, Reserve Banks were always faced with the problem of dealing with incoming gold rather than with the necessity of attracting gold from abroad. The reserve ratio, that is, the ratio of reserves to total liabilities, has been so high during most of the life of the Federal Reserve System that it could be and has been ignored. Another difference from the British precedent has already been mentioned, namely, the practice that the discount rate should be above the market rate. This is due to the existence of a different money market structure in America as evidenced by the fact that, unlike in England, member banks in America borrow directly from the Reserve Banks.

(*c*) *Open Market Operations.*—Open market operations have been more important than alteration of discount rate as a means to controlling cre-

dit in the U.S A When the Reserve System desires a contraction of bank credit, its first operation has generally been not to raise the discount rate, but to sell securities in the open market, when it desires an expansion of credit, it purchases securities in the open market. The effectiveness of purchases and sales of securities in the open market as an instrument of policy lies generally in their influence upon member bank indebtedness to the Reserve Banks. Such purchases and sales do not ordinarily increase or diminish the amount of Reserve Bank credit in use. Purchases of securities, however, enable member banks to pay off their loans to Reserve Banks and thus make money easier. Sales of securities, on the other hand, increase the borrowings of member banks and thus make money firmer. Open market operations are undertaken on the advice of the Federal Open Market Committee.

(*d*) *Direct Dealing with Individual Banks.*—This method can only have a limited applicability for Reserve Banks would find it extremely difficult to ration credit among member banks The relationship between the Reserve Bank and a member bank is largely impersonal. Further, if a member bank has eligible papers to offer, loans are granted as a matter of course. It may, however, be possible for the Reserve Banks to deal effectively with a limited number of banks, which may clearly be abusing the borrowing privilege by using Federal Reserve credit for too long periods in very large

amounts, or which may obviously be expanding credit for speculative purposes It may be mentioned that the Reserve Banks are statutorily enjoined to refuse credit to any bank which may be making undue use of bank credit for speculative purposes. But, as already stated, direct action can be taken against only a few banks which are clearly abusing their borrowing privileges To apply it more generally may place the Reserve Banks in a position in which they may have to assume responsibility for the management of member banks.

(e) *Publicity.*—The views of the officials of the Federal Reserve System are made public through official publication of the System or other forms of public statement, and these exert an influence upon financial conditions comparable in influence with specific instruments of policy. The statement issued by the Federal Reserve Board in February 1929 warning against excessive use of credit for security speculation was a case in point. The Reserve System issues various publications concerning not only the System itself but also credit and business conditions. Thus, the weekly published statement of the affairs of the Federal Reserve System is one of the most revealing statements of any bank of issue in the world. Among other publications are a weekly report of the condition of member banks in principal cities and a monthly bulletin containing a comprehensive review of credit and business condi-

tions, both published by the Board of Governors. The effectiveness of publicity as an instrument of control depends, however, upon the rarity of it's use.

(*f*) *Changing Member Bank Reserve Requirements.*—The Banking Act of 1935 confers upon the Federal Reserve Board a power to alter the reserve requirements of member banks. The amount of increase was limited to 100 per cent of existing requirements with a view presumably to allay apprehension of too severe action. This instrument will be found useful at times when, for example, member bank reserves are too high to be absorbed by the sale of the entire government security holdings of the Reserve Banks. But as excess reserves of member banks are not likely to be evenly distributed between them, resort to this instrument may hit some banks harder than others.

(*g*) *Adjusting Margin Requirements on Security Loans:*—The effects of the boom of 1928-29 and the subsequent depression focussed attention on the necessity of instituting measures for curbing security speculation. The Banking Act of 1933 contained two provisions for tackling this evil. First, it compelled commercial banks to give up investment banking business by relinquishing their security affiliates. Secondly, it placed certain restrictions on the availability of credit for carrying securities This power, it will be noticed, is a somewhat paternal power, but is a real attempt to deal

with abuses in the use of credit for security speculation.

New York as an International Financial Centre

Before the first Great War, New York played an insignificant role as an international financial centre. The U. S. A. was primarily a debtor country and New York lacked the other pre-requisites of an international money market. The first War transformed this position and New York's eminence in international finance dates from that time. The important factors in this development may be mentioned In the first place, large sums were loaned during the War of 1914-18 to foreign governments, which familiarized the American public with the problem of foreign investment In the second place, the financing of foreign trade stimulated the development of acceptance business, and made bankers familiar with the intricacies of the financing of international trade. Lastly, the War also made the investors and financial institutions in America more internationally minded. The period after the War up to about 1925 again favoured the growth of New York as an important centre of international finance. The dollar was then the most stable currency freely convertible into gold. America also became the largest capital exporting country. The supremacy which New York attained during the period of financial instability in Europe was, however, considerably lost, particularly as compared with London, when more or less stable conditions were restored in European countries. This fact demonstrates that New York had not been able to develop those features which could enable it to wrest the supremacy permanently from London but that its predominant position after the first War was in a large measure due to the break-down of the European financial centres.

New York's supremacy was achieved in too short a period for it to acquire the training and experience necessary for a leading financial centre. The policy of freezing to a large extent gold inflows and the abandonment of the gold standard in 1933 for reasons which could not be considered compelling detracted from the prestige of New York as an international financial centre. Further, New York was unable to develop an acceptance market, which offers the best scope for investment of short-term funds, comparable to that in London. The most important constituent of the New York money market is the brokers' loan market, the activities of which as the stock-exchange boom of 1929 demonstrated, may lead to disastrous consequences. For all these reasons, and particularly since the abandonment by the U. S. A of the gold standard in 1933, New York could not achieve ascendancy over London as a financial centre of international importance. It will be interesting to observe whether after the last War, which has witnessed the liquidation of British foreign investments and the transformation of Britain into a debtor country as well as American ascendancy in financial and economic matters, New York will wrest permanently from London the supremacy the latter has so long enjoyed in the international financial sphere.'

CHAPTER XV

THE MONETARY SYSTEM OF FRANCE*

THE monetary system of France presents certain peculiar features. Although the outward facade is more or less the same as that of Great Britain or the U. S. A.—a central bank, commercial banks, accepting institutions of some kind, a short-term money market being common features,—yet there are interesting differences between the character of the banking system and short-term money market of France and that of Britain or the U. S. A. For one thing, the Bank of France is in certain respects more like a big commercial bank than a central bank. For another, the short-term money market at Paris has never reached a high stage of development, and has played a role subordinate to that of the investment market. For yet another, the Government through the Treasury exert a direct influence on the money market and the relationship between the Treasury and the Bank of France is unsatisfactory. The important financial institutions in France are the Bank of France, the *Caisse des Dépôts et Consignations*, the Treasury and the commercial banks.

I.—THE BANK OF FRANCE

The Bank of France is the most prominent institution of the French money market. Its influence on credit conditions is great, although it makes no claim to manage money or control credit, nor does it seek to dominate the money market. The Bank has, however, certain privileges and responsibilities which clearly make it a 'central bank', as the term is normally understood. It receives its charter

from the Government and has the monopoly of note-issue. In return, it makes a permanent loan to the Treasury without interest, pays a share of its earnings to the Treasury, and has to maintain a reserve in gold against notes and deposits. The Bank enters into relation with and carries out transactions in Paris for other central banks. In contrast to all other central banks, the primary task of the Bank of France is to provide credit at a low rate to all who need it, whether banks or the general public, and other objects which are often considered to be the task of a central bank have been kept subsidiary to this main purpose. At the end of 1926, the Bank had about 661 branches and agencies.

Organization and Administration

The Bank of France was founded in 1800 by Napoleon. The law of 1803 formed the first official charter of the Bank; and, although many new laws have been passed since then, the original law of 1803 has never been repealed. By this law the Bank of France which had previously been just another large bank with a certain amount of Government patronage came to be re-organized as a central bank. It could no longer be dissolved by the stock-holders, as its existence was now determined by the Government.

Like most other central banks, the ownership of the Bank of France is entirely private, and is widely distributed among small investors. The control exercised by the stockholders is, however, less democratically distributed than the ownership. For only the two hundred largest stock-holders of French nationality are eligible to take part in the General Assembly of the Bank, which elects the fifteen Regents and three Censors forming the General Council. The stockholders also assemble once each year in the Gold Room of

the Bank to listen to the annual Report of the Governor, but their approval of the Report is not even invited.

The management of the bank is vested in a General Council, consisting of a Governor, two Vice-Governors, fifteen Regents and three Censors. The Governor and the two Vice-Governors are appointed by the President of the Republic, and are responsible only to him. The others are elected by the two hundred largest stock-holders of French nationality. The General Council must contain at least five representatives of manufacturing, industrial or commercial interests, and three Treasury officials. Less than half of the Council can therefore consist of bankers. Another noteworthy fact is that the large joint-stock banks have had relatively little influence in the Council, compared with the private and provincial banks, which, because they were organized earlier, have played a more important role in the development of the Bank. One result of this has been the ability of the Bank to act independently of the big commercial banks, but it has at the same time generated a feeling of competition between the Bank and the joint-stock banks, and made the latter unwilling to accept the leadership of the Bank in crises.

The relationship between the Governor and the Council depends largely upon the personality of the former. It is the legal duty of the Council, acting through various committees, to approve bills for discount, to issue notes, to invest reserve funds, to make rules for the internal management of the Bank, and to make sure that the Bank is conducting its operations within the law. The Governor is the executive officer, and the Council can do nothing without his approval. A strong Governor can ordinarily lead the Council. It will be evident that, although the Bank is privately owned, the Government can exercise considerable

influence over it through the Governor, the Vice-Governors and the Treasury representatives on the General Council.

Note Issue

The Bank of France began to issue notes as soon as it was founded in 1800. Originally it was, without exclusive privileges, merely authorized to issue notes. Since 1848, it has been the sole bank of issue in France.

The principle that has been followed from the very beginning in the matter of issuing notes is that 'the guarantee of bank-notes ought not to be sought in the capital funds of the Bank, but in the bills which it discounts'. In thus stressing commercial paper as security behind notes rather than gold reserves or Government securities the Bank of France followed the principles of what came to be known as the 'banking school' in England, whereas the English Bank Charter Act of 1844 incorporated the principles of the 'currency school'.

By the original Act of 1803, the Bank of France was given the monopoly of note-issue in Paris only. No important change in the method of note-issue was made until the crisis of 1847 endangered the metallic reserve. In that year, the minimum denomination of notes was lowered from 500 to 200 francs, and a temporary expedient was adopted which later became a permanent policy, namely, the setting of an upper limit to the total circulation—350 million francs for the Bank of France, and 102 million francs for the nine departmental banks combined. The serious plight of the departmental banks in 1848 led to the Bank of France obtaining the complete monopoly of note issue in France, the nine departmental banks being transformed into branches of the Bank of France. Since 1847-48, the denomination of the notes had been lowered from time to time

until in 1871 the issue of 10 and 5 franc notes was authorized, and the legal maxima to the total issue of bank-notes had also been altered during periodic crises. This setting of a maximum limit was known as the 'plafond' system. The 'plafond' was raised in 1870, 1884, 1893, 1897, 1906 and 1911 in which year it stood at 6,800 million francs. Specie payment was suspended and the 'plafond' was raised to 12,000 million, and in 1925, to 58,500 million. The monetary law of 1928, which gave effect to the stabilization of the franc, did not abandon the original principles of note-issue in France. The rules for rediscounting, which form the basis of a large part of the issuing of notes, were not changed But as this device was not considered sufficient to protect notes from over-issue by other means, the Bank was also required to hold 35 per cent reserve in gold coin or bars against total notes in circulation and deposits. The obligation to redeem notes in gold was restored, but since the Bank was given option to pay out coin or bars and to set its own conditions in respect of minimum amounts and fineness, the legal resumption of specie payments did not restore gold to circulation.

The Bank of France and Foreign Exchange

Until 1914, the Bank had taken no part in foreign exchange transactions. During the first Great War, the Bank began to take more active interest in the market, mainly selling through regular dealers enough exchange from the proceeds of its foreign holdings to stabilize the market. In 1924 and 1926, these operations became more frequent for the purpose of counteracting foreign speculation against the franc. When in 1926, the scheme for the stabilization of the franc was evolved, exchange operations of the Bank formed an integral part of it, and the Bank organized a

department which began operations in October 1926. Through its purchases, the value of the franc was gradually raised, and after December it helped to keep the value of the franc pegged until June 1928, when the legal stabilization of the currency no longer made such purchases and sales necessary. Nevertheless, the foreign exchange department of the Bank still exists and operates as the principal factor in the exchange market. The importance of the department was demonstrated when the dollar exchange was fluctuating greatly. The aid it gave to the dollar was reciprocated in May 1935 when the stabilization fund of the U. S. Treasury supported the franc. In this way, the establishment of the foreign exchange department marks another step in the development of co-operation between central banks and in the adjustment of domestic policies to the exigencies of the international situation.

II.—Caisse des Dépots et Consignations

The Caisse des Dépôts et Consignations constitutes the most unusual, and often the most important, French financial institution. Its greatest development has been since 1926 Its assets have approached those of the Bank of France, and by lending or not lending, it has at times even decided the fate of Governments. Its operations, however, are conducted so discreetly that it has attracted very little public attention, and is more or less unknown outside France.

The *Caisse* was established in 1816 when public confidence in banks was rudely shaken Its purpose was to keep in safety funds entrusted to it by individuals and by the courts, and the money put up as bond by certain government officials. The types of funds which have increased rapidly since the first War are not those which were origi-

nally in existence. The new types of funds are the savings bank deposits and social insurance funds. The various social Insurance Acts which have been enacted in France have greatly widened the scope of state-administered insurance, and the *Caisse* has received the full benefit of this circumstance. Although it cannot advertize, the insurance it offers has many advantages over that offered by private companies. The guarantee of the state is behind it, and, further, it is free from certain legal restrictions imposed upon private companies. The result is that the volume of insurance written by the *Caisse* since the new social insurance Acts were passed between 1828 and 1933 has increased much more than that written by private companies. The savings bank deposits have constituted in recent years by far the largest part of the *Caisse's* liabilities, amounting at the end of 1931 to two-thirds of the total. By a law in 1837 deposits of private savings banks had to be transferred to the *Caisse*. The deposits of postal savings banks are also entrusted to its management. Savings deposits increased rapidly since the stabilization of the franc, partly owing to renewed confidence in the Government as the result of the return of sound money and partly owing to loss of confidence in banks and in securities investments during the depression years. The maximum amount that an individual may deposit is now fixed at 20,000 francs. This limit for many years before the first War was placed at 1,000 francs and has been changed from time to time and stands now at 20,000 francs.

Management

The Management of the *Caisse* is entrusted to a Commission consisting of a representative of the Treasury, the Governor of the Bank of France or one of the Vice-

Governors, the President of the Chamber of Commerce of Paris, one of the presiding judges of the Court of Accounts, two Cabinet Ministers, two Senators and two Deputies. Actually this Commission entrusts the real direction of the *Caisse* to the Director, who is appointed by the President of the Republic, upon the nomination of the Minister of Finance.

THE CAISSE AND THE MONEY MARKET

The *Caisse* invests its very large funds in short, medium and long-term loans. A certain portion has to be kept in liquid form in order to meet demands for withdrawals of saving deposits, payments of insurance and other sums for which the *Caisse* is liable. A part of this is maintained in cash and a larger amount is kept on deposit with the Bank of France Another amount is kept on deposit at the Central Fund of the Treasury, while the rest of the short-term funds are invested largely in the notes of French and foreign Governments, or in loans granted against the security of such notes

The *Caisse* influences the short-term money market in many ways. It is the largest holder of the two-year Treasury notes, and in a large measure controls this market. It also holds such notes as collateral for loans granted to banks and individuals. The rate of interest charged by the *Caisse* for loans against Treasury notes is lower than that levied by the Bank of France, with the result that banks often approach the *Caisse* rather than the Bank for short-term accommodation. The influence of the Bank in the money market is thus seriously affected The lending activity of the *Caisse* could be carried on without any unfavourable reaction upon the leadership of the Bank of France, if the two institutions worked in close co-operation. There is a

slight official connexion between the two institutions ; for the Governor of the Bank is an *ex-officio* member of the Council of the *Caisse*. But this link is not a close one, and the policies of the Bank and the *Caisse* have sometimes been in conflict The objects of the two institutions are different. The primary function of the *Caisse* is to safeguard the funds entrusted to it, not, like the Bank, to manipulate interest rates or to control gold movements The former is merely concerned with the safety, liquidity and profitability of its assets. Yet its funds, like those of the Treasury, are so large that, unless they are skilfully handled in co-operation with the Bank and the Treasury, they are bound at times to exert a disturbing influence on the money market.

CAISSE AND LONG-TERM INVESTMENTS

A very large part of the funds of the *Caisse* is by law invested in securities issued or guaranteed by the government. It is the largest single holder of French government securities. Until 1931, ninety per cent of the savings banks deposits had to be invested in government and semi-government securities. The law of March 1931 allowed investment in industrial issues as well, but under special safeguards. Thus the Minister of Finance must approve the list of such issues drawn up by the Director of the *Caisse*.

From the position of the *Caisse* as a holder of long-term securities, especially government and semi-government, certain consequences follow. From the point of view of the government the interdependence of the *Caisse* and the French Rente may prove dangerous. From 1926-1932, the increase in savings deposits made the *Caisse* a very strong supporter of the Rente. When, however, the movement reversed, it became a menace to the credit of the Government, for, in an emergency, the *Caisse* may be forced to

sell its holdings of the Rente which would create panic in the market and undermine public credit. In the second place, when a number of banks were in extreme difficulty in the depression years, it was generally believed that the *Caisse* helped them not only to give loans but also by purchasing the stock Such action has dangerous possibilities. For, if the *Caisse* which now controls all savings bank deposits and a large part of insurance funds, should acquire control of the banks by purchase of their stock, it might achieve a dangerous monopoly of all financial transactions in the country.

III —The Treasury

The Treasury is an important financial institution in France It does not always act through the Bank of France, but may directly intervene in the money market in many ways and influence conditions therein.

Treasury Borrowing

Whenever the Treasury is short of funds, it borrows in the open market by issuing Treasury notes. This borrowing is handled by the Treasury directly from its central office by means of three to twelve months notes sold to banks and other investors, and should be distinguished from long-term borrowing, as well as from the National Defence notes, which are administered by a separate branch of the Treasury, the *Caisse d' Amortissement* Negotiations for the sale or issue of Treasury notes are usually carried on directly with the principal banks, without calling upon the Bank of France for any special assistance. The state of the market determines the amount of notes to be issued and the rate of interest to be paid. Notes of three months maturity or less have always been eligible for rediscount by the Bank of

France with the borrower's endorsement, while notes of longer maturity were admitted to special privileges by the Bank in 1935 and could usually be used as security for loans from the *Caisse des Dépôts et Consignations*. Banks were therefore enabled to hold large quantities of notes without endangering their liquidity.

All long-term debts contracted by the Treasury since 1926 are managed by a separate office called the *Caisse d' Amortissement*. It also managed all debts contracted during the first War and up to 1926. Its first duty was to take over the short-term National Defence notes and redeem them as far as possible and to refund the rest in notes of at least two years' maturity. The *Caisse d' Amortissement* is administered by a council of twenty-one members including representatives of the Treasury proper, the Bank of France and of the *Caisse des Dépôts et Consignations*. The Director of the latter is the head of the financial committee of the *Caisse d' Amortissement*, and the two institutions work in close collaboration.

Loans by the Treasury

The Treasury has the right to invest its funds as it pleases. One of its most important short-term investments during and after the war has been in foreign exchange. But when the Treasury no longer needed foreign currencies, it would sell them independently of the Bank of France, which might also be carrying on the same operation.

The Treasury has also the right to make long-term loans. This privilege has produced many difficulties in France as it has sometimes been used for political purposes. Thus after 1926 when the government had surpluses for some years, loans were made, not always with sufficient care, to

a number of countries whose friendship was considered desirable on political grounds.

The Treasury and the Bank of France

It is a peculiar feature of the French monetary system that the relation between the Treasury and the central bank is rather loose, although this situation appears to be in conformity with the Bank's anxiety to maintain its independence of the Government. The Treasury in France is in many respects an independent financial institution. It performs many functions which are of a banking character. The Treasury has its own central fund, where Government receipts are often hoarded in actual cash and deposits are kept for administrative bodies like the *Caisse des dépôts et Consignations*, the city of Paris and the Departments. Until 1926, individuals and banks were allowed to have deposit accounts with the Treasury on which 3 per cent interest was paid.

The Bank of France handles, of course, a large part of Government receipts and disbursements, particularly since 1926. Yet the relation between the Bank and the Treasury is neither very close nor of much assistance to the money market. There is little co-operation between them in matters of policy. For example, apart from such funds the Treasury may maintain with the Bank, the latter knows nothing of the status of the Treasury's funds, of what foreign balances it holds, nor of the policy in regard to them. It may be mentioned that during 1930 and 1931, the Treasury was selling foreign exchange when the Bank was refraining from doing so. Further, the Bank is not always consulted as to the conditions under which a new issue of notes is to be placed in the market by the Treasury.

IV.—The Commercial Banks

An important factor in the development of banking institutions in France is that the country's principal industry is agriculture, not manufacture or trade. There has been less emphasis upon commercial banking than upon the investment of savings deposits. Cash transactions preponderate over credit transactions, and the use of the cheque has been limited. The result is that an important source of earning for commercial banks has been the investing of funds for their customers, while investment and private bankers have tried to attract deposits to augment their funds for placement.

The commercial banking system of France has developed with comparatively little government regulation or supervision, and may be classified into four main groups: (*a*) credit banks or *banques de dépôts*, (*b*) investment banks, or *banques d' affaires*, (*c*) local and regional banks and (*d*) private banks, or *hautes banques*.

Credit Banks

The credit banks—the *grandes sociétés de crédit*—are the most important group of banks, and may be compared with English joint-stock banks. They provide short-term loans to trade and industry and also discount trade bills. They are also in close contact with the small investor, who usually buys his securities over their counters or upon their advice. The distribution of securities constitutes an important business for the credit banks. With their numerous branches and agencies all over the country, they collect the surplus funds of the public and do a large business in distributing securities to it. These securities may be either domestic or foreign. The banks cannot deal directly on the Bourse or

the Stock Exchange, but they have their own counters inside the Stock Exchange premises from which they issue buying and selling orders for their customers, and are thus in closer contact with the security market than are banks in most other countries. Unlike the German banks, however, the French credit banks do not directly participate in business enterprises, but merely act as distributors of their securities.

The three largest of the credit banks are *Crédit Lyonnais, the Société Générale*, and the *Comptoir National d' Escompte*. They are the leaders in the commercial banking sphere They have a network of branches and agencies all over the country In addition to these three institutions, there are two others of a definitely metropolitan character, although not so large as the others. They are the *Crédit Industriel et Commercial* and the *Banque Nationale pour le Commerce et l'Industrie.*

Banques d' Affaires or Investment Banks ·The investment banks are chiefly concerned with the provision of long-term finance for business establishments, and engage in commercial banking to only a small extent. Their main business consists of floating government loans, underwriting industrial loans, and organizing new industries or re-organizing old ones to a point where their issues can be offered to the public. Sometimes the manager or a director of the investment bank may have a seat on the board of directors of a client company, but it is considered advisable to exercise control by other indirect means. The relation of the investment banks with the public is partly direct, and partly indirect, through the commercial banks, with whom they stand in close relationship. They may be compared with the security affiliates formerly associated with American banks, with this difference that whereas the

security affiliates were dependent on the mother bank, the French investment banks have an independent existence.

The investment banks depend mostly upon their own capital supplemented by funds left with them by capitalists. They accept deposits from the public, but the greater proportion of these deposits are time deposits. During the first War and for some years after the War, however, some of the investment banks, owing to lack of investment opportunities, had begun to solicit deposits from the public with a view to do more commercial banking business. They expected in this way to make up for the declining earnings of their securities departments

The most important investment banks are the *Banque de Paris et des Pays-Bas* and the *Banque de l'Union Parisienne.* The former institution engages primarily in investment banking and is responsible for the development of many industries as well as for placing many foreign issues in the French market. *The Banque de l'Union Parisienne* was interested in general commercial banking business, even before the first War, in addition to its main business of investment banking.

PRIVATE BANKS

The most highly specialized investment banks are the private banks or the *hautes banques*, many of which belong to international banking families such as Rothschild, Hottinguer, Mallet and Varnes. These banks do not undertake general banking business, nor do they accept deposits from the public. Their activities are quite varied. Some of them manage their own business. Their customers are usually the big industries. Their main business is to invest their funds in French Rentes or issues of other governments. In view of their international connexions, the big private banks

have always been influential in financing international trade, and have played a role similar to that of merchant bankers in England. The smaller private banks also operate in the foreign exchange market and do an acceptance business. The smaller banks usually serve as feeders either to the large investment banks or to the large private banks.

Local and Regional Banks

Alongside the large credit banks, there are in France a large number of local banks and a few regional banks. In France, the development of branch banking on the part of the big commercial banks has been mainly by the establishment of new branches, and not by the absorption of existing local banks The local banks have met this competition from the large credit banks partly by combining themselves with other institutions in a particular locality and thus forming regional banks, and partly by the advantage they have in view of their intimate knowledge of local conditions. During the depression years, a number of local banks suffered badly and some of them failed.

Some of the local banks are intimately associated with local industries, which they finance. Such banks are in the nature of investment banks. Others carry on a commercial banking business only. Generally speaking, the local banks do not maintain as liquid a position as the big commercial banks do.

The Bank of France and Control of Credit

The emphasis of the Bank of France as a central bank has been rather on service than on control of the money market. This is evidenced, in the first place, by the fact that it advances money to or rediscounts paper for any borrower, bank or private individual who satisfies its eligi-

bility requirements This character of the Bank is also manifested, in the second place, in its policy of maintaining the discount rate low and in changing it much less frequently than other central banks. The stability of the rate has been considered as important as its low level.

The Bank's Discounts and Advances

The discount facilities of the Bank of France are available to all borrowers provided the paper offered satisfies the essential requirements, namely, that the paper bears three signatures, is of short maturity, and arises out of a genuine transaction. The Bank charges a uniform discount rate to all borrowers, and does not allow any favoured rate to special customers of very good credit standing, as some central banks do. The strict requirements for discount have placed the Bank in a disadvantageous position in modern times. In the past, it had few competitors and its volume of rediscounts was large. With the growth of the large commercial banks and their activities, there has set in a decline in the discounts of the Bank of France The Bank has thus gradually become, in a sense, more a banker's bank than a commercial bank.

The Bank has not only suffered from the competition of commercial banks in the matter of rediscounts, but the quality of paper brought to it has also deteriorated. The commercial banks can offer preferential rates for the best bills and have thus been able to secure them. As the Bank's rate is a little higher, the commercial banks would suffer a slight loss if they were to take these bills to the Bank for rediscount. In actual practice, however, the big commercial banks hardly ever rediscount with the Bank, not only because of the financial loss involved, but also because of loss of prestige which such a transaction would

entail. It is considered to be equivalent to a confession of weakness if any of the big banks of Paris should try to rediscount bills with the Bank of France. They would rather borrow from each other or on their Treasury notes at the Bank or the *Caisse des Dépôts*.

Besides rediscounting commercial and Treasury Bills at the official discount rate, the Bank of France makes other forms of advances at other rates. It grants loans against bar gold or securities. Originally the securities could only be French Government securities of fixed maturities. Subsequent legislation enlarged the group of eligible securities to include bonds and stocks of French railways, and securities of French cities and departments, of French colonies and protectorates and of the *Crédit Foncier* and the *Société Général Algerienne*

The Bank and the Discount Rate

It has been the consistent policy of the Bank of France excepting during one period between 1852 and 1861 to maintain a stable and low discount rate. An attempt was made during 1852-61 to stop the gold outflow by raising the discount rate from time to time. Although this achieved partial success, it roused great public criticism. A Commission of Enquiry was appointed by the Emperor in 1865-66, and the Bank was practically forced to abandon its new policy and return to the earlier practice of stable and low discount rates. It should, thus, be evident that the discount rate has not the same meaning in France as in other countries. It is not generally used to control the volume of credit for the purpose of regulating production and prices.

The Bank and Open Market Operations

The Bank of France does not engage in open-market

operations except to a very limited extent. It is not authorized to buy or sell Government bonds or commercial bills on its own account, except in a very limited form. French public opinion has always been opposed to giving the Bank this privilege on the ground that it would expose the Bank to risk of loss and also rouse suspicion of its having manipulated the market, and, further, that in the other countries this had sometimes led to inflation.

Under the stabilization law of 1928, the Bank of France was permitted to buy and sell bills and short-term securities for the account of foreign central banks at their request. This was intended as a measure of reciprocity for services rendered to the Bank by other central banks, and cannot be regarded as a privilege to undertake open-market operations, for the initiative for such operations does not lie with the Bank of France, but must come from foreign central banks.

The only effective method of influencing credit conditions by open-market operations available to the Bank of France is dealing in foreign exchange. But as this operation must affect at the same time the external value of the currency and therefore the exchange rate, it has not been resorted to for influencing credit conditions.

It would appear from the foregoing considerations that the question of controlling the volume of credit by the central bank is not so important in France as in other countries. The Bank of France is primarily concerned with maintaining easy credit conditions. Further, it has to share its influence in certain respects in the money market with the *Caisse des Dépôts et Consignations*; the Treasury and the big credit banks. This peculiar position of the French money market is accounted for by certain traits of French economy. For one thing, the use of bank credit is much less important in France than in England or America. For

another, one of the main problems of the French financial system is the collection and safe investment of the small savings of numerous small investors. For yet another, the investment market in Paris is much more important than the money market from both the foreign and domestic points of view.

PARIS AS AN INTERNATIONAL FINANCIAL CENTRE

Neither before or after the first Great War or the stabilization of the franc in 1928, has Paris even been an important international financial centre. There are many reasons why this is so. In the first place, compared with London, Paris is not a great entrepôt centre. Nor is it like London or New York, situated in a very wealthy and highly industrialized country. In the second place, the international trade of France has not been so important as that of England, and there has been almost a complete absence of financial transactions arising out of French shipping and insurance services to other countries. In the third place, the short-term money market of France is not well developed. The facilities for the safe and liquid investment of short-term funds in Paris are very poor. The acceptance market in Paris is almost negligible. A beginning has, however, been made in 1929 by the formation of the *Banque Francaise d'Acceptation,* which is intended solely for acceptance business. The only aspect of international finance in which Paris has been interested is foreign long-term investment. Even here, the intrusion of political considerations has detracted from the influence and prestige of Paris an an investment market. Lastly, Paris has not been able to develop as a well-organized and well-knit money market on account of the jealousy existing between different financial institutions as well as unwilling-

ness on their part to co-operate Thus the leadership in the Paris money market is divided between the Bank of France, the Treasury, the *Caisse des dépôts et Consignations* and the big commercial banks All these factors have militated against Paris developing as a leading international financial centre, in spite of great opportunities, as, for example, when the franc alone was on the gold standard after this standard was abandoned by both England and America in 1931 and 1933 respectively

CHAPTER XVI

THE MONETARY SYSTEM OF GERMANY

ALTHOUGH the development of banking in Germany dates from the seventeenth century,—the first joint-stock bank being, however, founded in 1848,—it bears strongly the impress of three statutes, namely, the Laws of 1875, 1924 and 1934 The distinguishing characteristic of the German banking system, which provides the classical example of continental as opposed to British banking practices, is that German banks actively participate in the development of industrial establishments. The German system is therefore usually referred to as a mixed as opposed to a purely commercial banking system. One result of this is that a functional classification of German banks is more difficult than in the other monetary systems we have so far studied.

THE REICHSBANK

The origin of the Reichsbank goes back to 1765 when the first bank of issue in Germany, the Koenigliche Bank, was founded. It was established as a state institution. In 1846, it went into liquidation but was reorganized as the Preussische Bank by an Act in 1847 which admitted private shareholders. The reorganized bank continued until 1875, when it was again reconstituted as the Reichsbank or the Imperial Bank of Germany. The main purpose of the Act of 1875 was to unify the German banking system by bringing it under the control of a central institution, in the administration of which the state should have a part. The Reichsbank was again drastically reorganized in 1924 in accordance with the Dawes Plan. The shares of the Bank

are privately held, although the Bank is under the control of the Reich.

The Reichsbank is Germany's central bank. It supervises the German monetary system, holds the gold reserve of the country and is the ultimate source of credit. It was the principal and is since 1933 the sole bank of issue In 1875, there were 33 other banks with the privilege of note issue, and the number declined to only four by 1906.

The main functions of the Reichsbank are to regulate the supply of currency, provide clearing facilities and control credit In addition to issuing notes, the Bank discounts certain specified types of commercial paper, makes loans against certain types of collateral and engages in open market operations.

Management: Under the law of 1924, the administrative functions of the Bank were in the hands of an advisory committee, a managing board and a general council. The advisory or central committee of twenty-one members was elected by the general assembly of shareholders. These members represented various professions. The managing board was appointed by the President of the Bank, subject to the approval of the general council. The general council was composed of fourteen members, seven of whom were Germans and seven foreigners. The President of the Bank was to be elected from among the seven German members by a majority of nine members—six of whom had to be Germans—subject to the approval of the President of the Republic. The general council elected one of its foreign members to serve as the Commissioner of Currency.

Radical changes in the management of the Bank have been effected since 1924. In accordance with the Young Plan in 1930, the foreign element in the general council was

abolished, and the number of members was reduced from fourteen to ten consisting exclusively of Germans. The Commissioner of Currency was also to be a German. Further changes were introduced by the law of 1938. The general council was abolished, and provision was made for the appointment by the Reich President of a managing board. The Reich President now nominates the President of the Bank for four years on the suggestion of the directors of the Bank. The Reich President also nominates for a period of twelve years the directors of the Bank proposed by the Reichsbank President. Under certain conditions the Reich President may dismiss the President and directors of the Bank

Note Issue Until 1933, four banks apart from the Reichsbank, had the privilege of note issue The aggregate amount issued by them was small and was fixed at a maximum of 194 million marks by the law of 1924. These notes were not legal tender The note-issue privilege of these banks was terminated by a decree in 1933 as of December 31, 1935.

By the law of 1924, the Reichsbank must maintain against its note issue a reserve of at least 40 per cent in gold and foreign exchange, of which 30 per cent must be in gold. Foreign exchange eligible as cover for notes consists of notes, foreign bills of not more than fourteen days' maturity, and sight drafts drawn on banks of known standing in important financial centres. The balance of the cover against note issue is to consist of discounted domestic and foreign bills of exchange with a maturity not exceeding three months. Under the 1924 law, the reserve can be allowed to fall below the legal minimum under certain conditions. Thus, the reserve can be reduced in an emergency subject to (*a*) the imposition of a graduated tax on the difference ;

(*b*) the maintenance of the discount rate at a minimum of 5 per cent, and (*c*) the increase of the discount rate from the minimum as the reserve falls. This system, thus, has the great merit of elasticity, for extraordinary demands can be met without difficulty by increasing the fiduciary issue in the manner prescribed by law. Since July 1931, the reserve has fallen below the statutory requirement, but the Bank rate has not been proportionately increased. The provision that the discount rate must not fall below 5 per cent if the minimum legal reserve is not maintained was suspended until September 1934 by a presidential decree issued in September 1932. The provision for the imposition of a graduated tax and the 5 per cent minimum discount rate when the reserve should fall below 40 per cent was abrogated by the amendments passed in 1933. Further, while the 40 per cent metallic reserve against notes is maintained, these amendments provide that a concurrent resolution of the central committee of stockholders and of the directors of the Reichsbank can empower the Bank to let the metallic reserve fall below the legal minimum. The effect of this provision, as stated by a noted authority, is as follows: 'As it has also been laid down that the securities thus bought (by the Reichsbank in the open market) are to be equivalent to bills for the purpose of note cover, and as the gold and foreign exchange cover is practically of little importance, there are practically no longer any limits to the issue of notes . . . . . . Actually the Reichsbank is no longer a note issuing Bank in the old sense, but a Bank to provide money for the state, i.e., for the tasks which the new state has set itself in the new Reich'.

Under the Act of 1924, the Reichsbank has also to maintain a reserve against its demand deposits. The reserve is to be 40 per cent liquid assets consisting of demand

Reichsbank and performs such functions as the Reichsbank is prohibited by law undertaking, and in particular the shifting of short-term funds into the capital market. It accepts deposits, and is not, like the Reichsbank, debarred from paying an interest on deposits. The scope of operation of the bank was broadened in 1930, and it was authorized to issue bonds up to five times its capital and reserves. Its primary function now is to finance foreign trade, particularly when long-term credit is required, for example, in trade with Russia, Turkey and other countries, and in the administering of blocked marks used to foster foreign trade The bank also played an important part in the task of the re-organization of the commercial banks in 1932.

The State Banks.—Besides the Reichsbank, four state banks had the privilege of note issue, the Bayerische Notenbank, the Saechsische Bank, the Badische Bank and the Wurtembergische Notenbank. This privilege was terminated by a decree in 1933 as of December 31, 1935. Apart from these four banks, there are other state banks which had no power to issue notes. These state banks do not operate for profit. Their principal function is to act as bankers to their respective governments. They are supervised by the states and their earnings go to the state treasuries. Their operations are generally confined to states, and communal or co-operative organizations within the state territories. Personal credit is advanced to a small extent only.

The most important state bank is the Prussian State Bank, generally known as the *Seehandlung*. Next to the Reichsbank, it is the most important public bank in Germany. On account of its huge deposits, on which, unlike the Reichsbank, it can pay interest, the *Seehandlung* exercises considerable influence in the money market. It is one of the

largest lenders and borrowers in the market. It is also the principal lender against stock-exchange securities. In view of losses sustained in 1926 on some of its private transactions, it has restricted its activities to dealings mainly with banks. All engagements of the bank are guaranteed by the Prussian state, which also receives the net profits made by it.

The Reichs-Kredit-Gesellschaft.—Although this institution is in the nature of a commercial bank, it is indirectly owned by the Reich. It is an interesting example of private banking activity on the part of the state. Its entire share capital is held by the *Vereinigte Industrie Aktien Gesellschaft*, usually referred to as the Viag, which is owned by the Reich. The Viag is a holding company for managing the Reich Government's interests in business enterprises. It has no branches, but nevertheless has close connexion with all provincial institutions and bankers It has been able to maintain its position quite well in the face of competition from the big commercial banks

Provincial and Communal Banks —These are small public institutions situated in provinces, cities and communes all over the country. Their business resembles that of state banks in the smaller states This group includes local savings banks, central clearing institutions (Giro Zentralen) and land banks.

The land banks are maintained by provincial governments. Their functions are partly to give agricultural mortgage credit, partly to give financial assistance to subordinate local authorities, and partly to act as regional control banks to the savings banks.

The German savings banks have a comparatively long history, the first being established in Hamburg in 1778. They were established with the purpose of promoting saving, particularly among the less well-to-do sections in

society They are almost exclusively the creation of municipal authorities, which guarantee their solvency In each state, they are regulated by law or administrative decree.

Above the savings banks and municipal banks, which are the primary organs of the communal banking system, were erected the district Giro Zentralen, and the Deutsche Giro Zentrale, Berlin, the latter, established in 1918, being the central clearing institution for the whole Reich. The main purpose of this higher Giro organization was to operate payments by book transfer (Giro payment) between one local bank and another, to which the task of distributing liquid balances between the banks was also added.

Commercial or Private Credit Banks

German credit banks originated in the fifties of last century. The first joint-stock bank, the A. Schaffhausenscher Bankverein, was founded in Cologne in 1848. Since then, joint-stock banks have been established throughout the country both in Berlin and in provincial towns, until by a process of merger and concentration, they have come to be controlled by what are known as the Grossbanken or big banks. The leading Grossbanken comprise the four D-Banken, namely, the Deutsche Bank, the Disconto Gesellschaft, the Dresdner Bank and the Darmstaedter and Nationalbank, and, in addition, Berliner Handels-Gesellschaft, and the Commerz-und Privat-Bank. Following the collapse of the banking system in July 1931, there has been a further process of reorganization, as the result of which the following banks remain as the most important German credit banks : the Deutsche Bank and the Disconto-Gesellschaft, the Dresdner Bank, the Commerz-und Privat-Bank, the Berliner Handels-Gesellschaft and the Reichs-

Kredit-Gesellschaft The latter, although a commercial bank in its operations, belongs to a holding company which again is owned by the Reich.

The joint-stock banks do ordinary commercial banking business and engage in long-period financing of industries. The distinctive characteristic of joint-stock banking in Germany is the integration of branches of finance which elsewhere are often separate This characteristic is a combination of British deposit banking with the long-term finance associated with the French *banques d'affairs* In fact, the rise of German joint-stock banks has gone hand in hand with the industrialization of the country. Banks which assist industries with long-term loans usually have their representatives on the boards of the industrial establishments they finance A characteristic feature of mixed banking has been for the banks to permit capital developments by taking overdrafts on current accounts. Later these loans have been repaid by issuing securities If the securities can be easily disposed of, this method of financing presents no serious difficulties. Until the repression of 1929 this system worked on the whole quite satisfactorily. But the experiences of the slump of 1929 were very unhappy. On the Continent particularly, many banks suffered great losses on account of industrial losses, with the result that in many countries legislation has compelled banks to separate their commercial from their industrial banking business. Thus, in the U S A., deposit banks have had to abandon their securities affiliates.

The commercial banking activities of the German joint-stock banks are similar to those of the deposit banks in other countries. They accept deposits, extend short-term credit, discount trade bills and finance stock exchange transactions through collateral loans.

The end of the last Great War witnessed a great change in the German banking practice. The War transformed Germany from a creditor into a debtor country. The great impoverishment of the country aggravated by the effects of the inflation made the importation of foreign capital essential for the re-organization of industries After the currency was stabilized on the adoption of the Dawes Plan in 1924, foreign capital began to flow into Germany. In 1930, these foreign deposits comprised about 35 per cent of the total deposits of the commercial banks. In addition to these deposits, German banks obtained from abroad a large amount of acceptance (reimbursement) credits for account of their customers. In these circumstances, German banks had to maintain a large portion of their funds in liquid assets Nevertheless, dependence on foreign funds to such an extent implied a constant danger that would materialize immediately foreign funds would begin to be withdrawn for any reason. This danger did manifest itself when the result of the elections of September 1930 caused considerable anxiety abroad Foreign funds began to be withdrawn, and foreign credits cancelled The situation became worse when the precarious position of the Austrian Credit Anstalt became known. Loans were obtained from the Bank of International Settlement, and the central banks of England, America and France, but they failed to ease the situation. The collapse of the largest German textile concern, the 'Nordwolle' led to a run on the Danat Bank, which suspended payment. This in turn led to runs on other banks. The situation became so serious that the government had to intervene and afford relief by adopting various measures including the establishment of two new institutions with a view to strengthen the banking structure in general and, in particular, to assist the weak institutions.

Further, a decree of September 1931 instituted government supervision of banks. An office of a Reichs-Commissioner for Banking and a Banking Board were set up for the purpose.

In September 1933, a Commission of Inquiry was appointed 'to inquire what functions should be given to the German banking system in order that German socialism may become a reality' In December 1934, a Banking Act, which continued and broadened the banking supervision instituted in September 1931, and embodied the main recommendations of the Commission, was placed on the statute book to become operative from January 1935.

THE BANK LAW OF 1934

This Act regulates all banks with the exception of the Reichsbank, the Golddiskontbank, the Post Office and certain other institutions of an official or special character The government is empowered to declare other types of business firms as credit institutions and doubtful cases are decided by the Banking Commissioner.

Liquidity Provisions.—The Act is designed to ensure the safety of the banking system not only by bringing it under the control of the government, but also by regulations governing the liquidity of banks.

The law provides that the cash reserve of banks must not fall below a stipulated percentage of the total liabilities less savings deposits to be fixed by the Supervisory Board. In addition, every credit institution must maintain a minimum ratio between its current liabilities and its secondary reserves These reserves shall consist of commercial bills with not more than 90 days to run and securities which will be accepted as guarantees for loans by the Reichsbank. The

ratio is to be fixed by the Supervisory Board and may differ according to the type of institution concerned, but must not exceed 30 per cent in any case.

Holdings of stocks, excepting those representing permanent participation, and bonds not quoted on the German stock exchanges, must not exceed a percentage to current liabilities to be fixed by the Supervisory Board according to the class of credit institution concerned, but limited in any case to a minimum of 5 per cent The total investments in real estate and permanent participations must not exceed capital and reserves of the institution concerned.

Loans.—Unsecured credits exceeding RM 5000 may be granted only on the presentation by a borrower of a statement of affairs or a balance-sheet, thus fully revealing his financial condition. Loans granted to a single individual must not exceed a certain percentage of the bank's capital to be fixed by the Supervisory Board. The law considers all affiliated companies as a single borrower. When the total indebtedness of one borrower at one credit institution exceeds RM 1,000,000 during a month, it is termed large credit and must be reported to the Banking Commissioner. The latter may inform the banks concerned if a borrower has obtained large credits from several institutions. This information should prove useful in preventing big business houses playing one bank off against another.

Savings Deposits.—These are defined as depostis of money that serve the purpose of investment and not of current payments. Withdrawals are permitted only against presentation of the savings book, and not through the clearing system or by cheque. The Act also provides that savings deposits shall be specially invested according to regulations published by the Supervisory Board.

Supervision.—The control over the banking system is a

three-fold one : (*a*) the Supervisory Board, (*b*) the Banking Commissioner, and (*c*) the Reichsbank.

The Supervisory Board resembles and replaces the Banking Board established in 1931 It is established at the Reichsbank and consists of seven members, namely, the President of the Reichsbank Directorate as Chairman, the Reichsbank Vice-President as Deputy Chairman, a person to be nominated by the Leader and Chancellor of the Reich, and the State Secretaries of the Ministries of the Interior, Finance, Economic Affairs and Food.

The Board, it will be observed, is intimately connected with the various executive departments of the government and with the Reichsbank. The object of this close association is to facilitate the adoption of a uniform system of control. Decisions and other orders of the Board are made by its Chairman The functions of other members are mainly of a consultative character. In the event of the opposition by any member to a decision, it is referred to the government for final disposal

The primary function of the Board is to safeguard the banking and credit system and to remove any defects found in it. Besides the specific duties and powers of the Board relating to capital structure, liquidity and the clearing system, the law gives the Board a blanket authority over all banking matters The Act states that it is the duty of the Board to eliminate abuses in banking, to institute appropriate measures when a bank is in difficulty and to require independent auditing of the yearly balance-sheets of all credit institutions The Board may also issue basic rules governing the management of the banks. The Board is further entrusted with judicial powers in connexion with the hearing of appeals against the decisions and rulings of the Banking Commissioner in certain cases. It has

authority to issue instructions governing the activities of the Banking Commissioner.

The Banking Commissioner.—This official alone comes into direct personal contact with banks in the discharge of his duties. He is appointed by the Chancellor of the Reich on the advice of the President of the Reichsbank, and is responsible for the administration of the Act in accordance with instructions issued to him by the Supervisory Board.

The Commissioner is in charge of the issue of licences for the establishment of new banks, and has wide powers over the establishment and continuance of banks. He can order banks to be liquidated and can decide whether the officials of a bank are trustworthy and suitable for their positions. He virtually controls short-term money rates through his ability to declare, as binding, majority decisions of central organizations regarding interest rates and the restriction of competition, and through his powers to issue such regulations himself, should central organizations fail to come to an agreement. He has almost unlimited rights to demand information about the business of banks. The degree of control exercised by the Banking Commissioner becomes evident when it is borne in mind that only certain of his rulings and orders can be referred for final judgement to the Supervisory Board. In all other cases, his decision is final and irrevocable.

The Reichsbank.—The Reichsbank has indirectly, if not directly, great powers of control over the credit and banking system. Its direct powers under the Act are limited, for example, the right to demand statistics from banks, the determination of the form in which they shall be supplied and the demanding of explanations of balance-sheets and profit and loss accounts. But its indirect influence is great

in view of the fact that both the President and the Vice-President of the Reichsbank are leading members of the Supervisory Board.

Banking in Germany, it will be noted, is subject to a dual control The Reichsbank has power to control credit, and is also invested with certain other powers under the Bank Law of 1934. It is thus in supreme control in so far as the quantity of credit is concerned. The qualitative control over credit is exercised by the Supervisory Board and its executive officer, the Banking Commissioner. The two aspects of control are, however, harmonized by the close relation which exists between the respective authorities.

THE REICHSBANK AND CONTROL OF CREDIT

The duties of the Reichsbank after its reconstitution in 1924 are four in number, namely, the control of the discount rate and of the operations undertaken by the Golddiskontbank, the rationing of credit and direct action on banks. The Reichsbank is prohibited from carrying out open market operations. In contrast with the Federal Reserve Banks, which rely mainly upon open market operations for controlling credit, the Reichsbank depends primarily upon the discount rate to achieve the same object.

Discount Rate.—In its discount rate policy, the Reichsbank has sought to regulate the flow of credit and maintain the stability of the German exchange. In view of the importance of foreign funds to Germany, exchange considerations have played an important part in this policy. Apart from this the Reichsbank has tried to maintain interest rates low and to divert funds from the money market, when conditions in it were very easy, to the capital market.

In pursuing these objectives in its discount rate policy,

the Reichsbank has been faced with considerable difficulties. In the first place, the great dependence on foreign funds has introduced a complication, for, if the discount rate was raised to discourage speculation, and internal expansion of credit, foreign funds flowed in and made conditions in the money market easy. On the other hand, if it was lowered to discourage the inflow of foreign money, banks found it profitable to borrow from the Reichsbank and expand credit. In the second place, during 1924 and 1925, market rates were always lower than discount rate. The discount rate was therefore practically ineffective. Further, joint-stock banks had another access to funds, in foreign markets, in times of difficulty. Up to August 1926, the time up to which the Reichsbank kept the mark pegged to the dollar, banks and indusrial establishments could either obtain funds from the Reichsbank, or borrow abroad and sell their foreign bills of exchange to the Reichsbank. The unpegging of the dollar, however, and the consequent risk of loss from exchange fluctuations, caused the banks partially to abandon this method of obtaining marks through the sale of borrowed foreign exchange. In the third place, control of the money market by the Reichsbank was rendered difficult during the first few years following stabilization by the independent actions of such institutions as the State Railway and the Post Office, which controlled large funds.

The crisis of 1931 witnessed a distinct change in the Reichsbank's discount rate policy The banking crisis of that year, which led to the adoption of rigid foreign exchange restrictions, the freezing of foreign balances by means of stand-still agreements, and the impossibility of obtaining foreign credits, brought to an end the Reichsbank's policy of regulating the discount rate with a view to conditions in foreign markets. Since the middle of 1931, the

discount rate policy has been determined primarily by domestic considerations.

Operations by the Golddiskontbank.—When conditions in the market have been very easy, the Reichsbank has used the Golddiskontbank to take surplus funds off the market and to transfer them to the capital market, so as to reduce the discrepancy between short-term and long-term money rates.

Credit Rationing—At the beginning of 1934, when borrowing from it increased greatly, the Reichsbank, instead of raising its discount rate, instituted a policy of credit-rationing. It fixed the amount of its loans and discounts outstanding on April 7, 1924 as the maximum volume of credit it would extend in future The policy of credit rationing was resorted to from April 1924 to the end of 1925, in the spring of 1929 and again in July 1931 In each case it coincided with the loss of confidence in the mark by both foreigners and German nationals

Direct Action.—A policy of direct action was instituted in May 1927 to curtail a speculative boom on the stock exchange. At that time, the discount rate proved ineffective in combating a stock exchange boom, and the President of the Reichsbank forced the large German banks to reduce their loans on securities used for stock exchange operations.

Berlin as an International Financial Centre.—Since the end of the Franco-Prussian War and until war broke out in 1914, Berlin was recognized as an important international market. The influence of Berlin increased after the establishment of the Reichsbank in 1875. An important characteristic of German commercial banking has been the great help it has given to the industrial development of the country. In the growth of German industrialization and consequent accumulation of national wealth,

German banks have played no insignificant role. They were also enabled in their turn by the growing national wealth to lend abroad, and finance foreign governments and industrial enterprises Although Germany lent a considerable sum abroad, her banks, however, continued to borrow short-term money from foreign centres Thus, during the period before the first War, Gemany, was at the same time a lender of long-term capital and a borrower of short-term funds.

The War of 1914-18 and the subsequent inflation not only converted Germany from a creditor into a debtor country, but also made her absolutely dependent upon foreign capital for the re-organization of her industries. She became only a borrower in the international markets and her influence as an international financial centre deteriorated. From 1924 to 1931, the Berlin money market was entirely under the influence of the movement of foreign short-term funds. After 1931, the National Socialist Party gradually became supreme, and financial and economic policy was made to serve national interests as conceived by the National Socialists.

PART III

INDIAN BANKING AND MONEY MARKET

CHAPTER XVII

THE INDIAN MONEY MARKET : ITS CONSTITUENTS

THE money market in India is divided broadly into two parts : the organized, sometimes referred to as the European or central, consisting of and controlled by banking institutions working on western lines, and the unorganized, also known as the Indian or the bazaar market, composed of money-lenders and indigenous bankers

THE ORGANIZED MONEY MARKET

The principal constituents of the organized market are the Reserve Bank, the Imperial Bank, the Exchange Banks and the Indian Joint-stock banks We shall give here a short descriptive account of these institutions

THE RESERVE BANK OF INDIA

An Act constituting the Reserve Bank of India was passed in 1934, and the Bank started work in 1935. Like many other central banks, the Reserve Bank is the creature of a statute, and differs in this respect from the Bank of England, which is a product of slow evolutionary growth

Central Banking Functions.—The Reserve Bank was set up with a definite purpose, to discharge the functions appropriate to a central bank The preamble to the Reserve Bank Act says that 'it is expedient to constitute a Reserve Bank for India to regulate the issue of bank notes and the keeping of reserves with a view to secure monetary stability in British India and generally to operate the currency and credit system of the country to its advantage'.

The utter inadequacy of the previous financial system, under which currency was in the control of the Government of India and credit was controlled by the Imperial Bank, was patent, for there was no one institution regulating currency and credit policy from the point of view of national economic interest. The Reserve Bank was established to remove this defect and to better minister to the currency and credit requirements of the economic life of the country. As a central bank, the Reserve Bank has a three-fold function. It is a note-issuing bank. Since the establishment of the Bank, it has been the sole authority for issuing notes Secondly, it is the bankers' bank, for commercial banks, which are scheduled to it, have not only to maintain with it a statutory deposit, but may also obtain accommodation from it, in times of difficulty and crisis, against eligible paper Thirdly, it is the banker to the government, both central and provincial

Organization—The Reserve Bank is a shareholders' bank In spite of considerable political pressure exercised in favour of making it a state institution—the 1927 Reserve Bank Bill was abandoned largely owing to this agitation—the Bank has been constituted as a shareholders' bank This is a welcome decision inasmuch as it is desirable that a central bank should not be made amenable to the influence of political or sectional parties in the legislature.

The original share capital of the Bank is Rs 5 crores, divided into fully paid-up shares of Rs 100/- each With a view presumably to secure a more or less even distribution of shares all over the country, it was provided that separate registers of shareholders were to be maintained at Bombay, Calcutta, Delhi, Madras and Rangoon. It was further provided, presumably for the purpose of preventing concentration of shares in a few hands and the consequent domination

of the Bank by them, that each shareholder should be entitled to one vote for every five shares held, subject to a maximum of ten votes. As shares can be transferred from one register to another, and be held in the name of different persons subject to the influence of a particular individual, both these purposes have in practice been considerably frustrated.

Management.—The management of the Bank is entrusted to a Central Board of Directors 'which may exercise all powers and do all acts and things which may be exercised or done by the Bank and are not by the Act expressly directed or required to be done by the Bank in general meeting'.

The Central Board consists of 16 Directors, namely:

(*i*) a Governor and two Deputy-Governors appointed by the Governor-General in Council after consideration of the recommendations made on that behalf by the Board;

(*ii*) four Directors to be nominated by the Governor-General in Council. The reason for this nominated element is explained in the following extract from the London Committee's report[1]:

> 'In view . . . of the fact that in the particular circumstances of India election may fail to secure the representation of some important elements in the economic life of the country, such as agricultural interests, we recommend that a minority of the Board should be nominated . . . it being understood that this power would be exercised to redress any such deficiencies.'

[1] Quoted by Findlay Shirras in an article in the *Economic Journal*, June, 1934.

(*iii*) eight Directors to be elected on behalf of shareholders of the various registers on the basis of two Directors each for the Bombay, Calcutta and Delhi registers, and one Director each for the Madras and Rangoon registers ;

(*iv*) one government official to be nominated by the Governor-General in Council

The Governor and Deputy-Governors are whole-time salaried Directors of the Bank. They hold office for a term not exceeding five years and are eligible for reappointment. The government official Director holds office during the pleasure of the Governor-General in Council A Deputy-Governor and the nominated Government official Director may attend any meeting of the Central Board, and take part in its deliberations, but are not entitled to vote. In the absence of the Governor, a Deputy-Governor may vote, if authorized in writing by the Governor. Other Directors, whether elected or nominated, hold office for five years

No Director and no member of a Local Board, whose composition is described below, can be a member of any legislature, Central or Provincial, unless within two months of his appointment, nomination or election, he ceases to be such a member. No salaried government official, or salaried official of an Indian State, or officer or employee of any bank, or Director of any bank other than a co-operative bank is entitled to be a Director or a member of a Local Board An elected or nominated Director, or any member of a Local Board, shall cease to hold office if, at any time after six months from the date of his nomination or election, he is not registered as a holder of unencumbered shares of the Bank of a nominal value of not less than Rs 5,000, or if he ceases to hold unencumbered shares of that value, and any such Director shall cease to hold office, if without

leave from the Governor-General in Council he absents himself from three consecutive meetings of the Central Board. The Governor shall convene meetings of the Central Board at least six times in each year and at least once in each quarter

Local Boards—A Local Board constituted for each of the five areas for which share-registers have been opened, shall consist of

(*i*) five members elected from amongst themselves by the shareholders, who are registered on the register for that area and are qualified to vote and

(*ii*) not more than three members nominated by the Central Board from amongst shareholders registered on the register for the area with a view to secure the representation of territorial or economic interests not already represented, and in particular the representation of agricultural interests and the interests of co-operative banks

A Local Board has mainly two functions. In the first place, the elected members of the Local Board shall elect from amongst themselves one or two persons, as the case may be, to be Directors of the Bank representing the shareholders of the particular area In the second place, the Local Board shall advise the Central Board on such matters as may be generally or specifically referred to it, and shall perform such duties as the Board may, by regulations, delegate to it.

Some other Features of the Reserve Bank—Apart from the separation of the Issue from the Banking Department, among other features of the Bank that deserve mention are the following :

(a) *Agricultural Credit Department* —It was a statutory obligation of the Reserve Bank to create a special Agricultural Credit Department, the functions of which should be (i) to maintain an expert staff to study all questions of agricultural credit and to be available for consultation by the Governor-General in Council, Local Governments, Provincial Co-operative banks and other banking organizations, and (ii) to co-ordinate the operations of the Bank in connexion with agricultural credit and its relations with Provincial co-operative banks or organizations engaged in the business of agricultural credit.

We shall deal with these functions of the Bank in greater detail in a later chapter.

(b) *Agreement between the Reserve Bank and the Imperial Bank* —This agreement, which is for a period of 15 years, is set out in the Third Schedule to the Reserve Bank of India Act. Under this agreement, the Imperial Bank has been constituted as the sole agent of the Reserve Bank at all places where there is a branch of the Imperial Bank in existence at the commencement of the Bank, and where there is no branch of the Banking Department of the Reserve Bank of India. The Imperial Bank gets a commission from the Reserve Bank for the performance of this service

(c) *Statutory Deposits of Scheduled Banks.*—A bank having a paid-up capital and reserve of not less than five lakhs of rupees is entitled to be included in the Second Schedule to the Reserve

Bank of India Act. All such scheduled banks have to maintain with the Reserve Bank a balance which shall not at the close of business on any day be less than five per cent of their demand liabilities and two per cent of their time liabilities A penalty is also imposed for non-compliance with this provision.

The Two Departments.—On the model of the Bank of England, the Reserve Bank of India maintains its Issue Department separately from the Banking Department The separation of the two departments is, however, not a common feature with all central banks

The following (pp. 204-5) is a weekly statement published by the Reserve Bank and relates to its affairs as on June 30, 1947

Issue Department—Liabilities —On the liabilities side of the Issue Department, the first item is the notes held in the Banking Department It will be seen that the amount of these notes agrees with the total notes shown on the assets side of the Banking Department These notes form part of the total cash balance of the Reserve Bank The next item is notes in circulation which is one of the most important items in the entire weekly statement. Notes in circulation comprise all notes issued by the Bank other than those held in the Banking Department, and include notes held by Government treasuries and commercial banks, as well as those in circulation among the public Changes in note circulation usually reflect the increases or decreases in the currency requirements of trade and industry During the busy season in India, owing to the increased requirements for money for financing crop movements there is usually a large absorption of currency and this absorption is generally followed by a return of currency during the slack season.

ISSUE DEPARTMENT

LIABILITIES	Rs.	a	p.	Rs	a.	p	ASSETS	Rs.	a.	p	Rs	a	p
Notes held in the Banking Dept ..	41,76,42,845	0	0				A Gold Coin and Bullion —						
Notes in circulation ..	12,23,54,99,132	8	0				(a) Held in India ...	44,41,44,701	1	3			
Total notes issued .				12,65,31,41,977	8	0	(b) Held outside India	Nil					
							Sterling Securities	11,35,32,89,317	1	4			
							Total of A .				11,79,74,34,018	2	7
							B Rupee Coin .				27,72,94,617	15	11
							Government of India Rupees Securities				57,84,13,341	5	6
							Internal Bills of Exchange and other Commercial Paper				Nil		
Total Liabilities Rs .	..			12,65,31,41,977	8	0	Total Assets Rs ..				12,65,31,41,977	8	0

Ratio of Total of A to Liabilities 93 237 per cent

BANKING DEPARTMENT

LIABILITIES	Rs	a	p	ASSETS	Rs	a	p
Capital paid up	5,00,00,000	0	0	Notes	41,76,42,845	0	0
Reserve Fund . . .	5,00,00,000	0	0	Rupee Coin . .	8,77,017	0	0
				Subsidiary Coin	1,35,260	3	5
Deposits —				Bills Purchased and Discounted —			
(a) Government—				(a) Internal .. .	*Nil*		
(1) Central Government of India .	3,90,70,10,476	10	0	(b) External . ..	*Nil*		
				(c) Government Treasury Bills .. .	2,43,56,132	8	5
(2) Other Government Accounts	17,99,57,040	2	5	Balances held abroad* ..	4,30,82,06,002	13	2
				Loans and Advances to Governments	5,11,00,000	0	0
(b) Banks . ..	88,90,79,801	9	7	Other Loans and Advances .	2,95,000	0	0
(c) Others .	30,96,49,063	11	5				
Bills Payable .	1,92,26,555	4	3	Investments	66,93,83,045	4	0
Other Liabilities ..	7,91,76,329	14	11	Other Assets	1,21,33,964	7	7
Total Liabilities Rs .	5,48,41,29,267	4	7	Total Assets Rs ...	5,48,41,29,267	4	7

* Includes Cash and Short-term Securities

Issue Department—Assets.—In India, the proportional method of holding reserves against notes has been adopted instead of the fixed fiduciary system which obtains in the U. K. The Reserve Bank of India Act lays down that the assets of the Issue Department shall consist of not less than two-fifths in gold coin, gold bullion or sterling securities, provided that the amount of gold shall not at any time be less than Rs 40 crores in value, and the remaining three-fifths may be held in rupee coin, Government of India rupee securities of any maturity and such bills of exchange and promissory notes payable in India as are eligible for purchase by the Reserve Bank, provided that the rupee securities shall not exceed one-fourth of the total amount of assets or Rs 50 crores, whichever is greater, or, with the previous sanction of the Governor-General in Council, such amount plus a sum of Rs 10 crores The suspension of the reserve requirements is permitted with the previous sanction of the Governor-General in Council on payment of a tax during such periods of suspension. The imposition of the tax is intended to prevent undue expansion. An Ordinance issued in 1947 did away with the restriction imposed on the holding of rupee securities, namely, that they shall not exceed one-fourth of the total amount of assets or Rs 50 crores, whichever is greater. It merely stipulated that not less than two-fifths of the assets of the Issue Department should be held in external assets, that is, gold coin, bullion or sterling securities, and that the value of gold held should not be less than Rs 40 crores. Accordingly up to three-fifths of the total assets can now be held in rupee securities, rupee coin, and internal bills of exchange.

On the assets side, the first item is the gold coin and gold bullion held by the Bank in terms of Section 33 of the Act, against the notes issued by it. This item is divided into

two heads, namely, gold held inside and gold held outside India. Gold held in India consists of bullion and sovereigns held in Government mints on behalf of the Bank as well as in branches of the Issue Department. At present the entire gold stock of the Bank is held in India.

The sterling securities which form a part of the statutory reserves against note-issue consist, in accordance with Section 33 (6) of the Act, of Government securities of the United Kingdom maturing within five years. As a result of conditions arising out of the war sterling has tended to accumulate with the Bank.

Banking Department—Liabilities —On the liabilities side of the Banking Department the first two items are the paid-up capital and the reserve fund The capital of Rs 5 crores, with the exception of Rs 2,20,000 which is held by the Government for disposal to directors to enable them to obtain the minimum share qualification, was subscribed for by the public The reserve fund of Rs 5 crores was provided by the Government in the form of Government securities in accordance with Section 46.

The deposits of the Bank are divided under three heads, namely, Government, banks and others. The Government deposits which are held by the Bank in terms of Sections 20 and 21 of the Act are further sub-divided into (1) Central Government deposits, (2) Government of Burma deposits and (3) other Government accounts. The other Government accounts include the deposits of the various Provincial Governments Since the fall of Burma, the second sub-head has been dropped

The bankers' deposits mainly comprise the deposits, lodged by the scheduled banks under Section 42 of the Act. The fluctuations in these deposits are an important index to the conditions prevailing in the money market. During

the busy season from November to May the excess deposits of the scheduled banks with the Reserve Bank usually show a decline but they generally increase during the slack season from June to October

The remaining two items on the liabilities side of the Banking Department are 'Bills Payable' and 'Other Liabilities' The former comprise mainly the various forms of bills drawn by the offices of the Bank upon each other while the latter include the various amounts held in suspense, principally transactions in transit between the offices of the Bank and profits for distribution to shareholders and to Government.

Banking Department—Assets—On the assets side the first three items are notes, rupee coin and subsidiary coin which together form the cash balance of the Reserve Bank. The notes held in the Banking Department have also been shown on the liabilities side of the Issue Department

Bills discounted have been sub-divided under three heads, namely, internal, external and Government of India Treasury Bills. Owing to the fact that the years following the establishment of the Reserve Bank of India witnessed an era of cheap money conditions, there has not been much demand on the Reserve Bank for the rediscount of commercial bills, and such bills as have been rediscounted have been for comparatively small amounts and mainly for seasonal requirements for crop finance. Moreover, owing to the special facilities given by the Reserve Bank for rediscounting Treasury Bills, the larger scheduled banks have preferred this form of borrowing. At present the Treasury Bills of the Central and Provincial governments are rediscounted by the Reserve Bank at rates which are slightly higher than those prevailing at the nearest weekly

tender, and which can be ascertained from time to time from offices of the Reserve Bank.

The balance held abroad includes cash and short-term securities held on account of the Reserve Bank by the Bank of England. The short-term securities consist entirely of United Kingdom Treasury Bills. Other United Kingdom securities are held under 'Investments'.

Ways and means advances to the Central and Provincial governments are grouped under the heading 'Loans and Advances to Government'. Such advances are made under Section 17 (5) of the Reserve Bank Act and are repayable in each case within three months from the date of advance.

The investments in the Banking Department consist of rupee securities of the Government of India and United Kingdom securities and include those delivered to the Bank by the Central Government in respect of its reserve fund. Under Section 17(8) the amount of rupee securities held in the Banking Department shall be so regulated that their total value shall not exceed the aggregate amount of the share capital of the Bank, the reserve fund and three-fifths of the liabilities of the Banking Department in respect of deposits. It is further provided that the value of the securities maturing after one year shall not exceed the aggregate amount of the share capital of the Bank, the reserve fund and two-fifths of the liabilities of the Banking Department in respect of deposits and that the value of securities maturing after ten years shall not exceed the aggregate amount of the share capital of the Bank, the reserve fund and one-fifth of the liabilities of the Banking Department in respect of deposits.

The item 'Other Assets' comprises furniture, fittings and stationery, as well as certain items in course of collection.

CHAPTER XVIII

THE INDIAN MONEY MARKET
ITS CONSTITUENTS
(*Continued*)

II —The Imperial Bank of India

The Imperial Bank of India occupies a unique place in the Indian money market. Up to 1934, it functioned as a central bank of a sort. Further, its vast size and resources place it far ahead of any other bank in the money market. Before the establishment of the Reserve Bank, when the Imperial Bank used to hold Government balances, its total deposits exceeded those of the Indian deposits of all the Exchange Banks, and often even the total deposits of all Indian joint-stock banks. Even after the creation of the Reserve Bank, when Government balances and certain other accounts had been transferred to it, the total deposits of the Imperial Bank until before the War were above the Indian deposits of all Exchange Banks, and not very much below the deposits of all Indian joint-stock banks. During the War, however, the deposits of joint-stock banks have increased much more than those of the Imperial Bank. This will be evident from the following figures :

Deposits of Banks in '000 Rs

	Reserve Bank	Imperial Bank	Exchange Bank (Indian deposit)	Joint-stock Banks
1934	...	81,00,15	71,39,37	81,88,38
1936	23,28,44	78,79,50	75,22,55	1,03,60,67
1941	56,14,00	108,92,00	106,73,00	1,49,09 00
1945	...	259,37,00	..	..

The Imperial Bank was not a real Central Bank.—Before the establishment of the Reserve Bank, the Imperial Bank, although it functioned in many respects as a central bank, was not a true Central Bank. It did not perform many of the essential central banking functions, and those that it did it more often than not performed only partially. It was not the note-issuing authority. The duality in control of currency and credit hampered its function as a regulator of currency and credit. It was not entitled to operate in foreign exchange business. Its main purpose was to work for profit, within, of course, the limitations imposed upon it by statute. The fluctuations in its rates during the year, and the level of the rates itself, bear testimony to this. It was, however, the holder of Government balances, but not entirely It was the agent for Government's financial operations but in part only. It held the reserves of other banks, and acted as a bankers' bank, but only partially, for there was a considerable hostility towards it on the part of other joint-stock banks. It, however, rendered considerable assistance in the matter of providing emergency credit by means of rediscounting.

Why the Imperial Bank was not set up as the Reserve Bank—Since the Imperial Bank was discharging, with some measures of success, some of the functions of a central bank, the question naturally arises as to why it was not itself constituted as the Reserve Bank. The answer to this is two-fold. To convert it into the Reserve Bank would, in the first place, have involved the shearing of its commercial banking functions. And to do this, in the second place, would be greatly detrimental to the cause of banking development in the country as well as of assuring cheap credit facilities to traders and other borrowers. Thus, the Hilton-Young Commission observed that 'the conversion of the

Imperial Bank into a true central bank would involve a radical amendment of its charter, and would preclude it from undertaking a great many tasks which it now successfully performs as a commercial bank. The country would then lose the benefit of the elaborate and widespread organization which has been set up through the length and breadth of India to make available to the community the increased commercial banking facilities, which are so urgently needed, and to assist in fostering, among the people as a whole, the habit of banking and investment. This consideration alone negatives the idea of disturbing the present functions of the Imperial Bank'.

The Imperial Bank up to 1934.—The Imperial Bank was formed in January 1921 by the amalgamation of the three Presidency Banks of Bengal, Bombay and Madras. Under the amalgamation scheme, which was given effect to by the Imperial Bank of India Act, 1920, the paid-up capital of the bank increased from Rs 3¾ crores to about Rs 6 crores.

Management.—The Boards of the Presidency Banks became the Local Boards of the Imperial Bank. The Central Board was constituted by the Presidents, Vice-Presidents and Secretaries of the Local Boards, the Controller of Currency, a maximum of two Managing Governors appointed by the Governor-General and a maximum of four non-official nominees of the Governor-General. Thus Government control over the business of the bank was complete. Further, the Governor-General was empowered to issue instructions to the bank with the specific object of safe-guarding Government balances or the financial policy of the Government.

Functions.—This large and effective control by the Government of the bank was essentially an outcome of its function as the Government's bankers. It held

the balances of the Government free of interest at places where it had offices, did the Treasury work of the Government free of cost, managed the public debt of the Government, provided the machinery for the floatation of loans, while its London office managed the rupee debt in London, receiving a fixed remuneration for the work. Among its other banking functions may be mentioned its role as a bankers' bank, the management of the Clearing House, and an obligation to extend banking facilities in the country, as evidenced in the statutory responsibility to open not less than 100 branches within the first five years of its inauguration This responsibility was duly discharged, for 102 new branches were opened by 31st March 1926.

Certain restrictions were specifically imposed on the business the bank could transact. It was, for example, prohibited from making loans for a period longer than six months, or upon the original security of immovable property, from discounting or making loans against any bill unless it carried the several responsibilities of at least two persons or firms unconnected with each other in general partnership, from granting unsecured overdrafts in excess of Re 1 lakh, and from transacting any foreign exchange business.

The Imperial Bank was not to have the control of the note-issue. That continued to be the responsibility of the Government.

The Imperial Bank at Work.—Although the Imperial Bank had not the authority to issue notes, it held Government balances, did Treasury work and functioned to a certain extent as a bankers' bank. With a view to assist the money market in the busy season it could obtain loans from the Paper Currency Department of the

Government up to a maximum of 12 crores at the Bank rate, subject to a minimum limit of six per cent for the first Rs 4 crores and seven per cent for the remaining Rs 8 crores on the security of internal bills of exchange or hundis of an equivalent amount. Commercial banks, inclusive of Exchange Banks, used to maintain, and still maintain, balances with it and approach it for accommodation against eligible securities, mostly Government paper, in times of stress. The rate which the Imperial Bank used to charge was for all practical purposes the then Bank rate in the country, although it should be noted that this rate was charged on advances against Government securities, and not commercial bills. It financed and still finances internal trade to a considerable extent by discounting hundis of approved indigenous bankers It further financed internal trade by providing cheap remittance facilities through the Treasury in places where it had no branches. It also rendered appreciable help to banks in distress, for example, the Tata Industrial Bank, the Bengal National Bank and some other banks in recent years. It managed the Clearing House. It provided and still provides remittance facilities between its numerous branches to other banks and to the public at cheap rates varying usually between ¼ and 1/32 per cent. A notable achievement to its credit is the considerable levelling down of interest rates and the stabilization of the money markets. Further, as already stated, it has rendered signal service in extending banking facilities throughout the country.

The Amendment Act of 1934.—On the constitution of the Reserve Bank, the Government have practically withdrawn from their association with, and control over, the Imperial Bank. The Bank, however, still operates under a special Act, the Imperial Bank Amendment

Act of 1934. This special treatment is a recognition of its unique place in the Indian money market, as well as of its special position as the agent of the Reserve Bank in places where the latter has no branches. Although the bank has ceased to be the banker to the Government, yet the Amending Act provides for the nomination by the Governor-General in Council of not more than two persons, as well as of a Government officer, on the Central Board. This officer is entitled to attend and participate in the meetings of the Board, but not to vote.

With the withdrawal of the special privileges previously enjoyed by the bank, such as the holding of Government balances and the management of public debt, the special restrictions imposed on the bank's business have also been largely removed. Under the amending Act, the bank is now authorized to open branches or agencies in India or elsewhere, to transact foreign exchange business, and to undertake banking business of any kind, including borrowing abroad. It can now buy and sell foreign bills of exchange of a currency of nine, instead of six months, if they relate to the financing of seasonal agricultural operations. It can make advances against goods hypothecated to it, instead of being restricted to advances only against goods in its possession or documents of title which are deposited with it. It can further accept as security for loans and cash credits Reserve Bank shares, municipal debentures, and securities of Native States, when permitted by the Governor-General in Council, as also debentures or fully-paid shares of limited liability companies, approved by the Central Board.

THE WEEKLY STATEMENT

Unlike any other commercial bank, the Imperial Bank,

although not obliged by law, publishes a weekly statement of its affairs, which is of great value to an understanding of money market conditions

III.—Exchange Banks

Exchange Banks are essentially commercial banks, like Indian joint-stock banks, but have their head offices outside India. They are foreign banks They probably derive their name from the fact that they are primarily engaged in the financing of India's foreign trade, and as such, have to deal largely in foreign exchange business. They have behind them a long record of service in India. They rank among the earliest joint-stock banks operating in this country, and have contributed not a little to the growth of joint-stock banking as well as of the banking habit in this country.

The principal business of these banks is the financing of India's foreign trade. They receive deposits of all kinds, current, savings and fixed ; they purchase bills in foreign currencies ; they make loans against shipping and other documents and finance imports of bullion In respect of import of bullion, it may be recalled that the gold bars of two banks, the Chartered and the National, particularly of the latter, used to be most popular. This business has, however, considerably declined in recent years. The Exchange Banks also finance some portion of the inland trade, mainly on account of goods in transit prior to export or immediately subsequent to import.

Business of Exchange Bank

Although it is usually claimed on behalf of the Exchange Banks that they are concerned principally with the financing of foreign trade and are not interested in inland

business, it would appear, however, that they are gradually extending their activities in this latter business. The outbreak of the war had further accelerated this tendency.

Indian Banks and Exchange Business

It is extremely unfortunate that Indian banks have so far practically avoided foreign exchange business. Their deficiency in this respect has not only meant loss of a large income to India, but also considerable difficulties to those engaged in foreign-trade business, and also in the way of Indians taking an increasing share in this business. In view of the great liquidity, safety and profitability of genuine foreign exchange business, the fact that Indian banks have fought shy of this business is to be deplored. The main reasons, as enumerated by the Central Banking Enquiry Committee, why Indian banks are practically non-existent in the foreign exchange business, are competition of well-established non-Indian Exchange Banks with large capital and reserves, the absence of branches of Indian banks in London and other foreign centres which precludes them from undertaking arbitrage and direct exchange business, the small profits now realized from the business, and the full employment of the resources of Indian banks in internal business of a more profitable character. The opinion of the Committee that foreign exchange business is now not so profitable is, however, not shared by some of the Indian banks which participate, although to a very limited extent, in this business. In spite of the reasons adduced by the Committee for non-participation by Indian banks in foreign exchange business, and there is much truth in them, the greatest handicap appears to be the unwillingness of Indian banks to enter this field owing mainly to their ignorance of the details of this business. A little more courage and ima-

gination, combined with the services of an expert personnel, would certainly enable them to undertake foreign exchange business to their own profit and to the great benefit of Indian businessmen

CLASSIFICATION OF EXCHANGE BANKS

Exchange Banks in India are usually classified into two groups · (*a*) those which do a considerable part of their business in India, that is, those which have 25 per cent or more of their deposits in India and (*b*) those which are merely agencies of large banking corporations doing a major portion of their business abroad, that is, having less than 25 per cent of their deposits in India. It is doubtful if this differentiation is quite satisfactory, for there are banks in the 'B' group which are very large world-wide institutions, for example, the Lloyds Bank or the Hongkong Shanghai Banking Corporation or the National City Bank of New York, the Indian deposits of which may be less than 25 per cent of their total deposits and yet may amount to a substantial absolute figure and exceed the Indian deposits of banks in Category 'A'. In 1937 there were six banks in Group 'A' and twelve in Group 'B'. In 1941, there were 5 banks in Group 'A' and 12 in Group 'B'; and in 1945 6 and 9 respectively.

INVESTMENTS OF EXCHANGE BANKS

Although figures of Indian deposits of Exchange Banks are furnished in the statistical tables relating to banks in India, no particulars are available in respect of their investments in India. This position is extremely unsatisfactory, inasmuch as no reliable estimate of their operations in the Indian money market can be made. Now that under the new Insurance Act foreign insurance companies have

CHAPTER XIX

THE INDIAN MONEY MARKET
ITS CONSTITUENTS

(*Continued*)

IV.—INDIAN JOINT-STOCK BANKS

OF the constituents of the organized money market, the joint-stock banks are the most important. All banks registered under the Indian Companies Act come under this category. The progress of Indian joint-stock banking has been remarkable in this century, and particularly since the last Great War. Joint-stock banks operate today over two-thirds of the centres with banking facilities in the country. Even as late as 1918, there were only 47 banks with a paid-up capital and reserve of Re 1 lakh and over, with 197 branches, and their aggregate paid-up capital and reserves amounted to Rs 6,65 lakhs, the deposits to Rs 42,15 lakhs, and cash balances to Rs 9,85 lakhs. In 1937 the number of these banks increased to 151 with 829 branches and offices, and their aggregate paid-up capital and reserves, deposits, and cash balances amounted to Rs 14,95, Rs 1,08,55 and Rs 18,15 lakhs respectively. In 1940, the corresponding figures for 180 banks with 1,177 offices were Rs 17,19, Rs 1,25,02 and Rs 28,51 lakhs respectively. In 1945, the corresponding figures for 306 banks with 4,047 offices were Rs 48,70, Rs 6,33,21 and Rs 1,36,51 lakhs respectively. Their importance *vis-à-vis* the Imperial Bank and the Exchange Banks is revealed in the table on page 221 :

In thousands

	Capital and Reserves			Deposits			Cash Balances		
	Exchange	Imperial	Joint-stock	Exchange[1]	Imperial	Joint-stock	Exchange[2]	Imperial	Joint-stock
	£	Rs	Rs	Rs	Rs	Rs	Rs	Rs	Rs
1918[1]	39,448	7,19,58	6,65,12	61,26,33	59,62,03	42,14,83	22,29,08	17,07,62	9,58,48
1928	187,923	11,01,72	12,29,37	71,13,86	79,25,30	65,35,02	8,05,57	10,58,00	8,71,09
1937	128,312	11,42,92	14,94,96	73,21,01	81,08,07	1,08,55,39	10,58,05	13,43,00	18,12,57
1940	128,686	11,63,61	17,19,48	85,57,47	96,03,12	1,25,02,41	16,53,28	24,82,81	28,50,66
1945	142,158	11,70,00	48,69,64	1,79,00,39	2,59,37,00	6,33,21,80	18,32,33	41,60,00	1,36,51,00

[1] Figures under Imperial Bank refer to the Presidency Banks.

[2] Figures refer to Indian Deposits and Indian Cash Balances.

RAPID GROWTH OF JOINT-STOCK BANKS

Three observations may be made on these figures. The first is the rapid expansion of the deposits of the joint-stock banks between 1918 and 1937, that is, within barely two decades. While the deposits of the Imperial Bank and the Exchange Banks increased by about 33 and 20 per cent, those of the joint-stock banks recorded an increase of about 160 per cent Again between 1937 and 1945, the rate of increase in the deposits of the Imperial Bank, the Exchange Banks and the joint-stock banks respectively has been about 160, 100, and 400 per cent. A comparative estimate of the growth of the joint-stock banks as beween 1918, 1937 and 1945 is given below :

	1918		1937		1945	
	Head offices	Branches and offices	Head offices	Branches and offices	Head Offices	Branches and offices
Imperial Bank ..	3	68	3	163	3	355
Exchange Banks ...	...	48	.	99	..	93
Joint-stock Banks ..	47	197	151	829	306	4,047

Various factors are responsible for this rapid development of joint-stock banks, of which some are general and others of special importance to Bengal The general factors are rapid industrial development, increased income and the growth of the habit of thrift. The depression of 1930-31 again witnessed a great fall in prices but no commensurate reduction in salaried incomes, with the result that an impetus was given to the growth of deposits. The factor of special importance to Bengal is the reaction of the great depression on the loan offices and investment in land. The fall in land values revealed the weakness of this popular

form of investment in Bengal, and was also responsible for the sorry plight of the loan offices. From the insecurity of such investments the public began to turn increasingly to banks for the safe-keeping of their surplus income. This process gave a great impetus to the growth of joint-stock banks in Bengal. The very large increase in deposits during the War has been in no small measure due to prevalence of inflationary conditions.

It is, however, pertinent to point out that the increase in deposits of the joint-stock banks is largely accounted for by an increase in the number of banks and their branches, and does not imply any strengthening of the average position of individual banks.

Thus in 1918 the average capital and reserve, and deposits per office were about Rs 2.7 lakhs and Rs 17 lakhs respectively; and the corresponding figures for 1937 were about Rs 1.5 lakhs and Rs 11 lakhs respectively and for 1945 Rs 1.1 lakhs and Rs 15 lakhs respectively. When, further, it is recalled that there are only a few joint-stock banks with very large capital and reserves as well as deposits, it will become evident that a good number of these banks must be small and weak institutions.

The second observation refers to the position of the cash balances of the joint-stock banks. This position compared with that of the Imperial Bank and of the Exchange Banks is revealed in these figures:

Percentage of Cash to Deposit Liabilities

	1928	1937	1940	1945
Imperial Bank ..	13	17	25·9	16·0
Exchange Banks ..	11	14·5	19·3	10·2
Joint-stock Banks ...	14·5	16·5	22·8	21·6

This comparatively satisfactory proportion of the cash

balances of the joint-stock banks should not by itself be interpreted as an indication of either their soundness or their liquidity. Such an interpretation would be possible only after an examination of the structure of assets of these banks. This study will be undertaken later.

In the third place, the figures quoted so far in relation to joint-stock banks, their number, branches, deposits, etc., are not complete. They refer only to such of these banks as have a paid-up capital and reserve of at least Rs 1 lakh. There are, however, numerous still smaller banks. Relevant figures in respect of all these banks are unfortunately not available. In a memorandum which the Reserve Bank submitted in connexion with its 'Proposals for an Indian Bank Act', it computed the total number of non-scheduled banks at 1,421. No details regarding capital and reserves of 101 banks were available. The capital and reserves of the remaining 1,320 banks as on December 31, 1937 were Rs 4,45 lakhs. The capital and reserves of the Indian scheduled joint-stock banks, which numbered only thirty, amounted on the same date to Rs 11,59 lakhs. These figures bear, generally speaking, an eloquent testimony to the comparative strength of scheduled and non-scheduled banks. In 1945, the number of reporting non-scheduled banks was 632, and their paid-up capital and reserves amounted to Rs 8,94 lakhs. The corresponding figures for scheduled banks were 75 and Rs 26,75 lakhs respectively. It is, further, noteworthy that the capital and reserves of the two biggest joint-stock banks only, the bank of India and the Central Bank of India, amounted in 1937 to Rs 5,09 lakhs and in 1945 to Rs 8,64 lakhs.

SCHEDULED AND NON-SCHEDULED BANKS

The Reserve Bank divides all banks into two broad cate-

gories: scheduled and non-scheduled banks We have already described in the last chapter how banks are scheduled to the Reserve Bank. It may be observed that while all non-scheduled banks are Indian banks, registered under the Indian Companies Act, the scheduled banks include the Imperial Bank and the Exchange banks, which are not so registered. In the following comparative table, the figures for scheduled banks refer to those of the Indian scheduled joint-stock banks only, that is, they exclude the figures for the Imperial Bank and Exchange Banks:

	In lakhs of rupees			
	Total number	Deposits	Cash in hand and at bank	Percentage of cash to total deposit liabilities
Non-scheduled banks, 1945 ...	632	1,03,70	34,18	33
Indian scheduled banks, 1945 ...	75	5,41,15	1,05,59	20

The average deposit per bank belonging to non-scheduled and Indian scheduled categories is Rs 16.5 lakhs and about Rs 721.4 lakhs respectively.

CONCENTRATION OF RESOURCES

A noteworthy feature of the Indian scheduled banks is the very large concentration of resources in the hands of a few banks This phenomenon, it should be underlined, is one of concentration of resources only, and not, as in Great Britain, of concentration in banking and consequently of resources also. As distinct from the development in Great Britain, there has been no large-scale process of amalgamation of banks in India. On the contrary, there has been a

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steady growth in the number of banks as well as in their branches. Apropos of branch expansion, it is interesting to observe that, while in Great Britain amalgamation has led to the closing down of many inefficient and unprofitable branches, in India, on the contrary, there has been a spate of branch expansion by individual banks with the result that many centres, particularly in the mofussil, have more banking establishments than can possibly be economically and *profitably* maintained

'THE BIG FIVE'

Following the British precedent, five Indian joint-stock banks are popularly designated as the 'big Indian five'. They are the Bank of India, the Central Bank of India, the Allahabad Bank, the Bank of Baroda and the Punjab National Bank. Of these, the Allahabad Bank is Indian in the sense that it is registered under the Indian Companies Act, but it is Indian neither in respect of management nor of control, for it is affiliated to the Chartered Bank of India, Australia and China. By far the largest bulk of the resources in the money market is, however, controlled by the Central Bank of India and the Bank of India, which may be referred to as 'The biggest two'. The figures on page 227 for 1941 and 1945 will be found interesting.

Thus, the big five banks control about 33, 55, 66 and 61 per cent respectively of the paid-up capital, reserves, total deposits and cash balances of all Indian joint-stock banks with a paid-up capital and reserve of over Rs 1 lakh. The corresponding figures for 1945 are 18,50,42 and 28 respectively. Not one of these five banks is from Bengal The comparative backwardness of the Bengali banks will be evident from the combined figures given above of the four largest Bengali banks, namely, the Comilla Banking Corpo-

	Paid-up Capital		Reserve		Total Deposits		Cash Balances	
					In lakhs of rupees			
	1941	1945	1941	1945	1941	1945	1941	1945
Indian scheduled banks, excluding Imperial Bank ...	8,41	26,75	5,19	11,99	129,04	541,15	24,21	105,59
Indian joint-stock banks having a paid-up capital and reserve of over Rs 1 lakh ..	11,96	34,67	6,77	14,03	149,09	633,22	28,36	136,51
The big five . .	3,95	6,16	3,73	7 09	99,67	268,39	17,51	37,81
The biggest two ..	2,68	4,00	2,45	4,64	67,18	164,25	12,09	23,97
The four big Bengali banks ..	45	2,20	19	82	6,99	39,76	1,67	8,99

ration, the Comilla Union Bank, the Bengal Central Bank and the Nath Bank.

Structure of Liabilities and Assets

Liabilities —The main items under liabilities are capital, reserves and deposits

Capital and reserves fulfil a dual purpose. In the first place, they serve as guarantee funds to the creditors of a bank. Secondly, they constitute funds which can be invested in assets which yield a comparatively higher return, for these funds can be invested for a comparatively longer period. The ratio of capital and reserves to deposits varies from country to country, and from bank to bank. A larger bank and one that enjoys public confidence may have this ratio lower than other banks. This ratio is usually 6 per cent among British joint-stock banks and between 15 and 20 per cent among Indian joint-stock banks with a paid-up capital and reserve of at least Rs 1 lakh.

Deposits —By far the largest bulk of a bank's resources is borrowed from the public. The important feature of these deposits is their division into demand and time

deposits. The Reserve Bank publishes figures of the demand and the time liabilities of scheduled banks since 1935. The figures for a few years are noted below:

In lakhs of rupees

	Number of banks	Demand liabilities	Time liabilities	Total
1935	49	1,21,93	98,67	2,20,60
1938	56	1,30,15	1,08,44	2,38,59
1941	62	2,24,73	1,12,79	3,37,52
1945	91	6,72,57	2,80,26	9,52,83

It will be seen that the demand liabilities of all scheduled banks are higher than their time liabilities. This is in striking contrast to the position of non-scheduled banks as the following table will show. The time liabilities of non-scheduled banks are now nearly double their demand liabilities, and this fact is indicative of their less liquid position.

In lakhs of rupees

	Number of banks	Demand liabilities	Time liabilities	Total
1938	626	3,83	11,59	15,42
1940	601	5,26	11,48	16,74
1941	601	7,06	12,48	19,54
1945	632	33,92	39,71	73,63

Assets.—An examination of the assets of a banking concern provides some indication of its solvency and liquidity. No precise or final judgement on the financial position of a bank is, however, possible merely on a study of the balance-sheet figures, for by far the largest item on the assets side is loans and advances. Without a careful scrutiny of the different constituents of this item, it is not possible to venture any opinion as to whether or not the bank is maintaining a satisfactory liquid position and conducting its business on safe lines and in accord with commercial bank-

ing principles. The composition of the assets portfolio will also be partly influenced by the composition of the liabilities side. If time liabilities should preponderate over demand liabilities, a bank need not maintain as liquid a position as it should in the opposite case. Further, what elements will constitute the assets side, and in what proportion, depend largely on the varieties and proportion of investments available to commercial banks from time to time within the territory in which they operate. International comparisons of the structure of assets of commercial banks may be largely vitiated, if due note is not taken of this fact It may be mentioned here that the general practice among British joint-stock banks before the war was to maintain about 10 per cent of their deposits in cash, 5 to 6 per cent in call money, 15 per cent in bills including Treasury Bills, 30 per cent in investments and about 40 per cent in advances. As against this, scheduled banks in India maintained about 13 per cent of their deposits in cash, 6 per cent in bills, 50 per cent in investments, and 40 per cent in loans and advances.

DISTRIBUTION OF ASSETS

Cash —The proportion of cash and balances with banks during the past four years is shown in the table (1) on page 230.

The decline in the cash ratio at the end of 1941 in the case of joint-stock banks was attributed partly to a rise in their investments in Government and other gilt-edged securities and partly to a rise in their advances.

Loans.—The table (2) on page 230 shows the proportion of loans and advances including bills discounted and purchased to deposits of the various classes of Indian joint-stock banks during the past four years

(1) In lakhs of rupees

	1938 (pre-war)	%	1941	%	1943	%	1945	%
Imperial Bank of India ...	8,99	11 0	15,27	14·0	53,36	24·9	41,60	16 0
Other Indian scheduled banks	13,44	14·6	21,21	18 8	74,25	22·9	105,59	19 5
Non-scheduled banks with capital and reserves over Rs 1 lakh	1,85	12·4	4,16	20·7	13,05	32·4	30,93	33 6
TOTAL .	24,28	12 9	43,64	16·9	140,66	24 3	178,12	20 0

(2) In lakhs of rupees

	1938 (pre-war)	%	1941	%	1943	%	1945	%
Imperial Bank of India .	38,30	47·0	38,88	35 7	40,60	18 7	72,97	26 1
Other Indian scheduled banks	48,85	53·2	62,76	48 6	108,93	33 6	220,91	40·8
Non-scheduled banks with capital and reserves over Rs 1 lakh ..	11,10	74 3	11,58	72 7	22,45	55 8	43,75	47·5
TOTAL ...	98,25	52·2	116,22	45·0	171,98	29 7	337,63	37·8

Compared to 1938, the ratio of loans and advances to deposits has considerably declined since after the outbreak of the War.

Investments.—The following table shows the proportion of investments in Government and other gilt-edged securities and shares of joint-stock companies to deposits held by

the various classes of Indian joint-stock banks during the past four years.

In lakhs of rupees

	1938 (pre-war)	%	1941	%	1943	%	1945	%
Imperial Bank of India .	43,72	53·6	64,39	59·1	130,20	60·7	154,18	59·4
Other scheduled banks . .	39,63	43·1	58,52	45·4	167,02	51·5	278,52	51·5
Non-scheduled banks with capital and reserves over Rs 1 lakh	3,41	22·8	5,80	28·9	10,04	25·0	27,66	30·0
TOTAL ...	86,76	46·1	128,71	49·9	307,26	53·0	460,36	51·9

The ratio of investments in Government and other securities which had been rising in previous years recorded a decline, inspite of an absolute increase in total investments, from 53.0 per cent in 1943 and 53 6 per cent in 1944 to 51.6 per cent in 1945 owing to a relatively higher rise in deposits

THE UNORGANIZED OR THE BAZAAR MONEY MARKET

We have in the last chapter, and so far in this chapter, described the institutions of the organized money market. We shall now provide a brief account of the constituents of the bazaar money market The principal constituents of this market are the indigenous banker or shroff, and the money-lender or sowcar. The money-lender is more important in rural areas, and we shall describe his activities in the chapter on Agricultural Finance.

An indigenous banker is an individual or a firm, which

deals in hundis, whether it accepts deposits or not. It may be mentioned that the Central Banking Enquiry Committee in its definition of an indigenous banker made acceptance of deposits by him as a necessary condition also. As in actual practice many indigenous bankers do not accept deposits, the definition suggested above is more in accordance with the facts.

Until the establishment of modern joint-stock banks, the indigenous banker enjoyed a virtual monopoly of banking in the country. With the advent of joint-stock banks, however, his importance has suffered considerable deterioration. Yet, despite competition from well-organized banks, a good deal of banking business still remains in his hands, and he still occupies a predominant position in areas which are not, or are only poorly, served by joint-stock banks. Like the Indian joint-stock banks, his share in the financing of foreign trade is negligible. But among the agencies financing internal trade and industries, especially in the matter of the provision of their working capital, he occupies an important position. He does not engage, to any large extent, in financing agriculture directly, but he renders considerable assistance to agriculture indirectly by lending money to village sowcars. The Bombay Provincial Banking Enquiry Committee observed that the shroff sometimes provides even the long-term capital needs of industries. In certain places he holds debentures in industrial concerns, and advances money against deposit of shares. Occasionally he also gives long-term loans against the security of fixed capital of industrial establishments.

Indigenous bankers normally work with their own capital supplemented in some cases by deposits from the public, but in busy seasons or during periods of active demand for loans, their resources may prove inadequate and they are

forced to take resort to banks for financial assistance. Commercial banks,—both Indian joint-stock and Exchange Banks—however, render assistance to only such indigenous bankers as are on their approved lists. There are limits fixed by the banks for each shroff who is on the approved list, up to which he can draw. The advances are usually made by discounting hundis.

One of the proposals of the Central Banking Enquiry Committee for linking up the indigenous banker with the general banking system was that 'as soon as the Reserve Bank is established, the indigenous banker should along with joint-stock and co-operative banks be brought into direct relations with the Reserve Bank, and thereby provided with rediscount facilities from that institution'. In the Statutory Report submitted by the Reserve Bank in 1937, certain proposals were put forward for compliance by the indigenous bankers for the purpose of linking them directly to the Reserve Bank. The most important of the conditions laid down by the Reserve Bank, which indigenous bankers will have to fulfil to qualify themselves to be linked up with the Bank, read as follows: 'They must confine their business to banking proper as defined by the Indian Companies Act. Any other business that they might be conducting should be wound up within a reasonable time.' Among other conditions are the requirements to maintain proper books of accounts, to have them regularly audited, and to allow the Reserve Bank to inspect accounts, call for necessary information and regulate the business of indigenous bankers on banking lines.

It is, however, not likely that the indigenous bankers will ever agree to the Reserve Bank's proposals. Nor is it possible for the Reserve Bank, consistent with its responsibilities and functions, to admit them directly as its

constituents unless its proposals are, in their essentials, agreed to. As the question of the linking up of the indigenous bankers directly with the Reserve Bank is not now found to be a practicable one, the only possible solution, as suggested by the Bank, is the development of an open bill-market in which first class bills will be freely negotiated. 'If such a market could be developed it would be possible for us (the Reserve Bank) to extend our open market operations to trade bills as we do at present to Government securities, and thus would give first class indigenous bankers the closer and possibly ultimately the direct relationship which they desire, without compelling them to modify the essential character of their business or to submit to unduly rigid restriction.'

CHAPTER XX

THE RESERVE BANK AND THE MONEY MARKET

THE primary function of the Reserve Bank is to control credit in the national interest. To effectively discharge this function, the Reserve Bank should be in a position to control both currency and credit. The control over currency is of the utmost importance, inasmuch as it is the basis for credit expansion. If the medium of payment consisted primarily of currency, then control over it would have ensured in a large measure control over the credit situation also If, on the contrary, cheques were the principal medium of payment, as in Great Britain or the U. S. A., mere control of currency would be of little avail in controlling credit. For mere control of currency would not affect the volume of bank deposits or 'bank money'. In a country, therefore, where the cheque habit is prevalent, the central bank should also be in a position to exercise control over bank deposits to fulfil effectively its purpose.

Of the chief forms of purchasing power in India, namely, the rupee coin, the currency note and the bank deposit, the rupee coin is of minor significance The principal media of payment are notes and chequeable deposits. Of these two, cheques have been gaining in popularity every year, although it is difficult to say if cheques have surpassed notes in importance as a medium of payment In this country at present, both these means of payment are probably of equal importance

The Reserve Bank has been statutorily entrusted with certain powers which have the object of facilitating its control over the monetary supply in the country. In the

first place, it has the monopoly of note issue. The duality of control over currency and credit which used to be a serious weakness of the Indian money market has been abolished with the establishment of the Reserve Bank. Secondly, the Bank has been entrusted with the duty of holding the cash balances of scheduled banks Besides, the holding of Government balances and the carrying out of the banking transactions of the Government provide it with useful means for exercising its control over the credit situation In the third place, section 18 of the Reserve Bank of India Act empowers it to deal directly with the public under certain conditions The section provides that when a special occasion should arise, making it necessary or expedient that action should be taken for the purpose of regulating credit in the interests of Indian trade, commerce, industry and agriculture, the Bank may exercise the powers of direct discounts and advances, that is to say, it may deal with the public directly in the open market without the intermediation of a scheduled or a Provincial Co-operative bank It is, of course, understood that this power will not be exercised except in very unusual circumstances.

THE RESERVE BANK AND CONTROL OF CREDIT

In evaluating the role of the Reserve Bank as a controller of credit, an obvious difficulty presents itself Although the Bank has been in existence for about eight years now, no serious occasion has yet arisen to test its hold over the market. Ever since its inception easy conditions have prevailed in the market and the necessity of invoking the aid of the Central Bank has not been felt by the market generally, which in India comprises mainly the commercial banks. It is noteworthy that up till now there have been

practically no bills in the Bank's portfolio other than Treasury Bills, which incidentally also bears testimony to the absence of a discount market in India, while 'other loans and advances', that is, other than those given to Governments, have been insignificant. The examination of the Reserve Bank's role as a controller of credit has therefore to be confined largely to certain theoretical considerations, which, however, should not be considered to be devoid of practical significance or implications.

There are certain features of the Indian money market which might cast doubt on the ability of the Reserve Bank to exercise any effective control over credit. There is, in the first place, the pre-eminent position of the Imperial Bank in the money market. But, as we shall presently see, this position of the Imperial Bank need not detract, as in fact it has not detracted, from the influence of the Reserve Bank as the custodian of the nation's financial interests. The Imperial Bank's peculiar standing in the market has evolved a novel procedure of control in India—a procedure which may prove beneficial to both the Reserve Bank and the market.

In the second place, there is in the market a group of banks, called the Exchange Banks, which if they should so elect, might frustrate a policy initiated by the Reserve Bank in view of their easy access to the London money market. But it is extremely unlikely that the Exchange Banks would take up an attitude which would run counter to the intentions of the Reserve Bank and to India's national interests.

In the third place, it is suggested that in a country like India, where the money market is not organized, the Reserve Bank can wield but little influence. Neither the experience of this country nor of that of other undeveloped

markets, however, supports this assumption. In South Africa, for example, the Reserve Bank was of great use in helping the commercial banks to negotiate the difficult deflationary period following the first War. It was also of material use to the National Bank of South Africa in 1923 when that bank suffered a loss of capital and consequent impairment of its credit. The Commonwealth Bank of Australia also rendered invaluable services in the difficult years from 1929 onwards. As the Canadian Banking and Currency Commission observes, the Commonwealth Bank[1] 'was instrumental in mobilizing the gold reserves of the country and their judicious employment with a view to tide the country over a period when Australia's ability to provide and to transfer the services of her overseas debt was seriously in question'.

In India, also, the Reserve Bank has provided sufficient evidence of its influence being felt in the market, although no occasion has yet presented itself to test the extent of its control over the market. The Reserve Bank has, further, another advantage which the central banks in Sounth Africa or Australia did not enjoy. In both these countries the advent of the central bank was viewed with considerable mistrust by the commercial banks. No such opposition existed in India to the idea of constituting a Reserve Bank, except probably only partially on the part of the Exchange Banks. Another advantage which has accrued to the Reserve Bank is the tradition, although in many respects imperfect, of central banking which the Imperial Bank has built up. In this tradition the role which the Imperial Bank discount rate played in its influence on other market rates deserves special mention.

[1] *Report of the Canadian Banking and Currency Commission*, p 216

As a positive evidence of the influence which the Reserve Bank has been able to exert in the money market may be mentioned the removal of seasonal stringency in the market, as demonstrated in a uniform Bank rate throughout the year. This has in its turn had salutary effects on other market rates. Prior to the establishment of the Reserve Bank, not only were the various rates high and fluctuating, but there was also much divergence between them. With the Reserve Bank in operation, considerable improvement has been effected in both these aspects, as the following figures will testify :

	Bank rate	Imperial Bank Hundi rate	Calcutta Bazaar rate	Bombay Bazaar rate
September 1929[1]	5	5	11	6
March 1930[2]	7	7	11	$9^{1}/_{16}$
September 1939	3	3	6-7	6
March 1940 ...	3	$3\frac{1}{2}$	6-7	$6\frac{3}{4}$

The table reveals not only a welcome reduction absolutely in all rates, but also a narrowing down of the divergences between them. A noteworthy feature is the absence of any great disparity now between the Bombay and Calcutta bazaar rates. This phenomenon may be interpreted as an indication of a more intimate and organic contact between the two markets, which presumably the establishment of the Reserve Bank has facilitated.

Another salutary effect of the establishment of the

[1] & [2] Imperial Bank discount rate.

Reserve Bank has been the impetus it has provided to the development of sound banking practices. In fact it is one of its statutory obligations to foster the development of banking on sound lines Its services in this connexion will not only improve banking standards, but also extend the scope of its control over the market.

The Reserve Bank has also been trying to develop a wider market in Treasury Bills, which, if it is accorded larger support by commercial banks, will facilitate its control over the latter.

The Reserve Bank and the Imperial Bank

It may be asked whether the unique position which the Imperial Bank occupies in the Indian money market constitutes any threat to the proper and efficient functioning of the Reserve Bank. Fortunately there appears to be no ground for the materialization of this danger. The relations between the two banks have been perfectly cordial, and there has been a realistic appreciation of the relative functions of the two banks in the Indian money market. If the Reserve Bank is the manufacturer of emergency credit in times of stress, the Imperial Bank will function largely as a wholesale dealer for its distribution to commercial banks, which again will retail them to the public. The scheduled banks, of course, can directly approach the Reserve Bank for accommodation, but there are two considerations which might incline them to prefer the Imperial Bank. In the first place, there is a longstanding relationship subsisting between the Imperial Bank, on the one hand, and the scheduled and other commercial banks, on the other. In the second place, the basis for obtaining accommodation from the Reserve Bank is narrow and strict. The

Imperial Bank is not so much hampered as is the Reserve Bank by statutory provisions. When it is satisfied about the credit and standing of the borrowing bank, the Imperial Bank is in a position to extend credit more liberally.

The Reserve Bank and the Bazaar Market

The question of the effectiveness of the Reserve Bank's control over the money market has, for obvious reasons, been confined so far to its organized section. In fact, the Reserve Bank cannot exercise any influence directly over the credit situation in the bazaar market. Unless indigenous bankers and money-lenders reorganize their business methods, the Reserve Bank will not be in a position to offer them any assistance. But the absence of any powers for direct influence does not mean that the Reserve Bank exercises absolutely no control over the bazaar market. It is well known that operators in the bazaar market have often to approach the Imperial Bank and other commercial banks for discounting their bills or for advances against approved securities. In so far as they are forced by conditions in their own market to seek assistance of institutions in the organized money market, they expose themselves, albeit indirectly, to the regulating influence of the Reserve Bank. Further, a closer correspondence in recent years between their rates and the Imperial Bank Hundi rate is a welcome indication of a gradual development of a more organic relationship between the two markets, and as such to a widening of the scope of influence of the Reserve Bank.

METHODS OF CONTROLLING CREDIT

Of the methods available to a central bank for regulating credit, the most important are the manipulation of the discount rate and open market operations.

I. *The Discount Rate*

The effectiveness of the discount rate is to be judged not only by its level but also by the papers which are considered eligible by the Reserve Bank for purposes of rediscounting and lending and by the relative importance of these papers in the money market. We shall take up the second aspect first.

It should be noted that the power of discounting bills and making advances which the Reserve Bank enjoys as a central bank has a twofold significance. In the first place, it is used for regulating credit. In the second place, this power of extending credit is limited to dealing in certain specified types of bills and securities. In this aspect, it represents the nature of assistance which scheduled banks may expect from the Reserve Bank in times of difficulty. It may be added that the question of assistance which member banks may expect from the Reserve Bank assumed particular importance during the crisis of the Travancore National and Quilon Bank, which ultimately failed to meet its obligations In the uncertain and anxious atmosphere which the failure of this bank generated, the Reserve Bank, with a view particularly to allay public criticism, clarified its position in the market *vis-a-vis* the scheduled banks. In respect of its lending policy, the Reserve Bank expressed the opinion that although it has a responsibility for providing credit against eligible paper, it does not necessarily follow that the Bank is obliged to lend whenever any eligible paper is brought to it. The Bank made it clear that in extending credit to scheduled banks, it will be influenced not merely by the nature of security offered, but also by other considerations such as the general character of the investments of the applying bank, the manner in which

its business as a whole is conducted, whether, for example, it attracts deposits by offering excessively high rates of interest, whether it seeks help from the Reserve Bank in normal times when funds in the market are ample, whether it has been overtrading and extending an undue amount of credit for speculative purposes in commodities or securities, or indulging in unsecured business to an excessive extent. These considerations are, however, common to central banking operations in all countries, and are essential for ensuring that banking development will proceed along sound lines

As the Bank rate has been maintained at 3 per cent ever since the inception of the Reserve Bank, it is not possible to express any definite opinion as to its effectiveness in practice

2 *Open Market Operations*

To supplement its discount rate policy, or even as an independent weapon to subserve particular ends, the Reserve Bank can influence credit conditions in the market by undertaking open market operations. This weapon operates by enlarging or contracting the cash basis of the commercial banks as a result of the purchase or sale by the Bank of Government securities. The effectiveness of this method depends largely upon the scope of the securities in which the Bank is entitled to operate as well as on the nature and organization of the market in which these operations are undertaken. The nature of the securities in which the Reserve Bank can deal is specified in sections 17(7) and 17(8) of the Act.

As to the nature and organization of the market from the point of view of its responsiveness to operations undertaken by the Reserve Bank, it is difficult to express an opinion

in the absence of knowledge of the result of actual operations. It would appear, however, that the Reserve Bank has resorted to these operations with satisfactory results, although probably not for the purpose of regulating credit.

It may also be recalled that the Reserve Bank is anxious to widen the market for Treasury Bills, although till now only a few big scheduled banks in the market, of which the Imperial Bank is the most important, render any active assistance to the Reserve Bank in this matter

Other Weapons

In addition to the two important weapons already mentioned, the Reserve Bank, it may be recalled, has also been entrusted with the authority to deal directly with the public in kinds of paper which are deemed 'eligible', but only under certain special conditions. This provision invests the Reserve Bank with special powers of considerable potency to force the commercial banks to follow particular policies initiated by it. It is, however, extremely unlikely that these powers will be used or even need be used, for the very fact that the powers exist should be a sufficient warning to commercial banks not to run counter readily to the wishes of the Reserve Bank.

Of the other instruments of control generally available to a central bank, those relating to the rationing of credit to and the taking of 'direct' action against 'scheduled' or member banks are as yet of little practical value in India, inasmuch as these banks are not large borrowers of central bank credit. Publicity has been used as a fruitful weapon only in the U. S. A. Its scope in India for controlling credit of member banks by making representation to the institutions concerned must obviously be very restricted. The reason for this is that these banks do not

yet use central banking credit to any appreciable extent. But moral suasion, in the sense of effecting an improvement in banking standards and practices as a result of representation or instructions offered by the Reserve Bank, can be, and has indeed been, of considerable practical effect.

Another method of control of an indirect nature may be fruitfully used in India. This is the growth of a healthy convention between the Reserve Bank and other important constituents of the money market. Its practical manifestation is seen in the relationship subsisting between the Bank rate and other money rates in the market, in which the latter rates follow the lead given by the former. The Imperial Bank, prior to the establishment of the Reserve Bank, developed a sort of convention of this nature, which the Reserve Bank should be in a position to render more effective.

CHAPTER XXI

AGRICULTURAL FINANCE

THE importance of agricultural or rural finance in a country where more than seventy-five per cent of its population live in villages and pursue agricultural activities, cannot be exaggerated. The establishment of a special Agricultural Credit Department by the Reserve Bank is an acknowledgement of the exceptional importance of rural finance in a country like India. It is indeed remarkable that in a statute dealing with the establishment of a Reserve Bank for India, provision was made for the creation of an Agricultural Credit Department as a part of the organization of such a Bank. The Reserve Bank was further statutorily entrusted with the responsibility for submitting proposals by the 31st December, 1937, for the improvement of the machinery for dealing with agricultural finance and methods for effecting a closer co-operation between agricultural enterprise and the operations of the Bank. This statutory report was duly submitted by the Bank to the Government on the 15th December, 1937.

CREDIT NEEDS OF THE AGRICULTURIST

The financial needs of the agriculturist have been variously classified. For example, his credit requirements have been grouped under the following heads, short-term, intermediate-term and long-term. Another classification consists of investment, operating and consumption credit, apart from credit required for repayment of debts. For our purposes, we may group the financial needs of the agriculturist into two broad categories, long-term and short-term. Long-term

credit is required mainly for (*a*) repayment of past debts, (*b*) purchase of land, and (*c*) improvement of land and methods of cultivation. Short-term or operating and consumption credit is required for such operations as the purchase of seed, sowing, ploughing, and weeding, the replacement of cattle or implements and the marketing of products, on the one hand, and such money as is ordinarily required for the maintenance of the cultivator's family until the crops are sold, on the other. Apart from such credits, there should be an agency for affording relief in times of exceptional distress, as is provided for under the Agriculturists' Loans Act.

SHORT-TERM CREDIT

The principal agencies for the provision of short-term finance to the agriculturist are the indigenous bankers, money-lenders and co-operative societies. Apart from these, there are a few other agencies of but little significance such as the commercial banks, the government loan offices in Bengal and nidhis and chit funds in Madras. These latter agencies play a small part in the provision of agricultural finance, and we shall leave them out of account.

Of the three principal agencies mentioned above indigenous bankers do not usually lend money directly to the agriculturist. To the extent that they provide agricultural finance, they do so mainly through the agency of money-lenders. The latter borrow funds from indigenous bankers to lend them out at a higher rate to the agriculturist. The main sources for obtaining short-term finance by the agriculturist are money-lenders and co-operative credit societies. Of these two sources, money-lenders have been much the more important.

MONEY-LENDERS

The money-lender is the most important indigenous credit agency, especially in rural areas. The fact which distinguishes him from an indigenous banker is that he does not usually deal in hundis. He does not usually accept deposits either. The money-lender may be a professional one who is also known as a *sowcar*, a *bania*, or a *mahajan*, these titles include itinerant money-lenders such as Pathans and Kabulis ; he may be, on the other hand, a non-professional money-lender such as a landowner, an agriculturist, a merchant, a trader, a pleader, a pensioner or a jobber, who pursues other activities but who lends out his surplus funds In certain provinces where legislation has been undertaken to control the operations of money-lenders, all money-lenders have to be licensed.

It would appear that the non-professional money-lenders are often more exacting than the professional money-lenders. The professional rural money-lender gives small loans on a mere entry in the account book, or no entry at all backed by a verbal promise, and without documents, but asks for promissory notes when the loans are large or old loans renewed. He usually gives loans for current needs on personal security on the understanding that the harvest is to be sold to or through him, or on the mortgage of crops. If the loans are large or taken for a long period, security in the form of mortgages of land, houses or ornaments is asked for. The non-professional landlord or agriculturist money-lender on the other hand, when he lends seeds on the security of future crops, or money on that of land, often eagerly awaits the opportunity of seizing both. The landlord money-lenders are most likely to abuse their powers as they secure a double hold over their tenant-borrowers,

who have to pay both rent and interest. In other respects, their operations and methods are similar to those of professional money-lenders. A merchant or trader money-lender lends money to cultivators on condition that the crops are sold to, or through him.

The finance supplied by the money-lender suffers from the defect that it usually carries heavy rates of interest and other vexatious conditions, and that he is not interested in the manner in which the agriculturist uses the borrowed money. What the money-lender is concerned with is the safety of his loan, not the purpose for which it is taken, nor whether the borrower can repay it out of his current income or not. The result is that money which is borrowed for short periods and which should be used for meeting current needs is spent for financing long-period requirements. Another consequence of these conditions is that an agriculturist, once in debt, is always in debt.

With a view to control the very high rates charged by the money-lender as also his many corrupt and vexatious practices, both the Central Banking Enquiry Committee and the Reserve Bank recommended that legislation should be undertaken for the regulation of the business of money-lending. The Punjab had already passed a law in 1930 called the Punjab Regulation of Accounts Act, under which all those who give loans at interest, excluding loans to merchants and manufacturers, have to maintain a separate account for each debtor in a prescribed way, showing the date and the amount of the principal of the loan, the rate of interest separately, the amount and date of every payment received by the creditor, and to furnish the borrower half-yearly a statement of account showing the amount of loan outstanding and all transactions relating to it. In recent years, many other provinces have enacted laws to control

the activities of money-lenders on more or less similar lines. In Bengal, a Money-lenders' Act was passed in 1938. Besides providing for the taking out of licences for engaging in the business of money-lending, and the control of the operations of money-lenders, the Money-lenders' Acts in the various provinces usually give the courts power to re-open accounts either when the interest is excessive or when the transaction is unfair. The Acts also lay down the rates that may be charged on secured and unsecured loans These rates are always simple interest rates and vary usually from 8 to 12 per cent on secured loans and 10 to 18 per cent on unsecured loans In Bengal, the maximum simple interest rates allowed on secured and unsecured loans are 8 and 10 per cent respectively. The Bengal and C. P. Acts provide that no court shall decree on account of arrears of interest a sum greater than the principal of the loan. The Bihar Act provides that arrears of interest on loans granted by a court shall not exceed, when added to interest already paid, the amount of the original principal.

Legislation to control usurious and corrupt practices of the money-lender is eminently desirable, but it should not be such as to rouse a feeling of nervousness among money-lenders, particularly in respect of sanctity of contract. Legislation passed to offer relief to the ryot in respect of the burden of his debts may often unfairly affect money-lenders' interests While, therefore, the money-lender's activities may be brought under control so that he may not exploit the cultivator's ignorance and financial difficulties, he should, at the same time, be given every protection to collect his just dues The money-lender is still a very important rural credit agency, and it would be unwise to do anything which would completely dry up this source. He can and does take more risks than any other

rural financial agency. As he has a more intimate knowledge of and contact with cultivators, he can take risks which a bank or a co-operative society would be unwilling to accept. Further, in times of depression, the money-lender can afford to be more lenient towards his debtors, as it is his own money he has lent out, than banks and co-operative societies which have to be more strict in the matter of the realization of their dues.

Co-operative Societies

Besides the money-lender, the other important rural credit agency is the co-operative society. The importance of co-operation as a rural financial agency has increased since the passing of legislation in various provinces aimed at scaling down rural indebtedness. These laws have the effect of scaring the usual credit agencies and diminishing the flow of credit As the prosperity of agriculture must ultimately depend upon an adequate supply of cheap finance for productive and useful purposes in the future, the only agency that can reasonably be expected to make up for the deficiency created by the contraction of private credit is the co-operative society.

The growth of the co-operative movement may be dated from the passing of the Act of 1904, which officially launched the movement in India. Since then, its progress has been more or less continuous till 1929. The development of co-operative credit in particular has been very rapid during the decade preceding 1929. With the onset of the depression in that year, the movement received a serious set-back One of the reasons for this set-back was the catastrophic fall in the prices of agricultural produce with a consequent fall in the income of the ryot. But certain other inherent defects of the co-operative movement were also

revealed during the depression period. It was found that the societies had lent money in the past in many cases without any proper security and much in excess of the paying capacity of the ryot. No effective steps were taken to encourage savings in good years with which the members could withstand the effects of the years of depression The increased income during the period of prosperity was mostly frittered away in extravagant and unproductive expenditure. Another serious defect of the movement was that it was mainly one-sided. Emphasis was mostly laid on the credit societies, while other aspects of the movement such as improvement in the method of production, supply of the various needs of the ryot and marketing on co-operative lines were neglected. Since the inauguration of provincial autonomy in 1937, interest has again been revived in the co-operative movement which since 1929 was more or less in a moribund condition. Popular ministries were anxious to ameliorate the distressed condition of the rural population. Legislation was passed to reduce debts and offer to the ryot relief in other forms as well, which prejudicially affected private credit agencies. In the circumstances co-operative societies received increasing attention.

Rehabilitation of the Co-operative Movement

The task of rehabilitation is by no means easy. An audit classification of agricultural primary societies in 1938-39 revealed that an appreciable proportion of the societies in different provinces—over 40 per cent in four provinces and about 25 per cent in three others—fall into 'D' and 'E' classes, and relatively few societies—less than 10 per cent in six provinces—come under 'A' and 'B' classes. In Bengal 1.4 per cent are in 'A' and 'B' classes, 46.8 per cent in class 'C' and 25.4 per cent in classes 'D' and 'E'.

PRIMARY SOCIETIES

The task of rehabilitation must begin with the primary societies and simultaneously proceed upwards. Reorganization should have two primary objectives. In the first place, primary societies should restrict their business generally to short-term loans and grant intermediate-term loans only to a limited extent. A preliminary to this is the necessity of instituting measures for restoring a balance between their realizable assets and their liabilities. The societies should also fix the normal credit limits of members and adhere to them strictly, exercise close supervision over the employment of loans, and take prompt action against defaulters while granting extension with reasonable facility in genuine cases of inability to repay. In the second place, the societies should extend their scope of activity beyond, as now, merely providing credit so that a comprehensive effort may be made to effect an all-round improvement in the ryot's life. In other words, as the Reserve Bank has urged the primary society should develop as a multi-purpose society. It should not merely be an agency for supplying finance but an influence for the all-sided development of agriculture and the betterment of the life of the villager from every point of view. 'Starting with credit for current needs, a society may get the old debts of its good members liquidated through a land mortgage bank, introduce better business and better monetary return by inducing its members to sell their produce co-operatively, ensure their growing improved varieties of crop by purchasing seeds for them, save on purchases by arranging for the purchase of their other needs jointly and at profitable rates on an indent system without incurring any risk or liability, save litigation expense by effecting arbitration, improve the outturn of

crop by consolidation of holdings, supply of pure seeds and improved implements, implement the income of its members by inducing them to take up subsidiary industries, introduce better living measures by adopting bye-laws by common consent which will curtail ceremonial expenditure and remove insanitary habits, provide medical relief, and so on'.

Central Banks

The rehabilitation of the primary societies along lines suggested above will call for a change in the outlook and operation of central as well as provincial banks Central banks should, in the first place, conduct their business along sound banking lines, and this condition applies with equal force to provincial banks as well. The criteria of sound banking, as laid down by the Reserve Bank, are in respect of the distribution of assets so as to maintain adequate cash and fluid resources, the maintenance of an adequate margin between borrowing and lending rates so as to build up strong reserves, the proper treatment of unrealized interest, the proper scrutiny of, and provision for bad and doubtful debts, the confining of business generally to short-term loans, the separate indication of long-term loans and overdues of principal and interest, and in general, the proper and accurate presentation of the affairs of the bank in the balance-sheet. Further, the central banks should broaden their outlook with a view to help the reorganization of the primary societies They should take a more intimate interest in the work of the primary societies, supervise and guide their operations, assist them in training their members in the principles of co-operation and generally in improving their work.

that the paper against which indigenous bankers may obtain accommodation from scheduled banks is not considered eligible paper.

Agricultural finance may also be obtained from the Reserve Bank through the agency of the provincial co-operative banks. The Bank, however, can supply only emergency or seasonal finance to tide over temporary difficulties. Financial accommodation from the Reserve Bank to the co-operative movement through the provincial co-operative banks may be available under the following heads :

(*a*) Loans and advances against Government securities for periods not exceeding ninety days to provincial co-operative banks and through them to central co-operative banks—section 17(4) (a). This accommodation will be available at any time subject to the limits and margins which may be laid down by the Reserve Bank.

(*b*) Similar loans and advances to provincial co-operative banks and through them to central co-operative banks against approved debentures of recognized land mortgage banks which are declared trustee securities, if the Bank considers that the debentures are readily marketable.

(*c*) Discount of Treasury Bills at rates which can be ascertained from the managers of the offices of the Reserve Bank from time to time.

(*d*) Loans and advances for periods not exceeding ninety days to provincial co-operative banks against promissory notes of approved co-operative marketing or warehouse societies endorsed by provincial co-operative banks and

drawn for the marketing of crops—section 17(4) (c), or rediscount of such promissory notes maturing within nine months—section 17(2)(b) ; or loans and advances for periods not exceeding 90 days on the promissory notes of provincial co-operative banks secured by warehouse warrants issued by corporations independent of the borrower or on the security of promissory notes supported by documents of title to goods which have been assigned or pledged as security for cash credits or overdrafts granted by the provincial co-operative banks to approved marketing or warehouse societies—section 17(4)(d)

(*e*) Besides making advances in the manner stated above, the Bank will also on occasions be prepared to make advances to provincial co-operative banks for a maximum period not exceeding 90 days against promissory notes of central co-operative banks endorsed by provincial co-operative banks and drawn for financing seasonal agricultural operations or the marketing of crops—section 17 (4)(c) ; or rediscount of such promissory notes maturing within nine months—section 17(2)(b). In this case the Bank would require more detailed information regarding the financial position of the central banks whose paper is intended to be rediscounted and the working of the primary societies financed by them This inquiry will be made with a view to ascertaining how far the loans and advances made by the central banks to the primary societies are liquid or otherwise.

> For the purpose of these loans the Bank would obviously have to confine itself to the paper of first class central banks run on approved banking methods.

In order to be able to obtain financial accommodation from the Reserve Bank, a provincial co-operative bank must maintain with the Reserve Bank cash balances equal to not less than 2½ per cent of its demand liabilities and 1 per cent of its time liabilities. Only two provincial co-operative banks had till 1941 taken advances of small amounts from the Reserve Bank against Government securities on a few occasions since 1938.

In actual practice, the Reserve Bank has not as yet been a fruitful agency for the provision of ample agricultural finance, even in periods of emergency. It is extremely doubtful if the situation will show any immediate improvement. For one thing, it will not be easy for the co-operative banks to separate their long-term debts from short-term obligations, or satisfy the reserve requirements indicated by the Reserve Bank. For another, agriculture is such a hazardous occupation and so much susceptible to the vagaries of the weather that it is hardly likely that loans granted by credit societies for even cultivation finance will be promptly repaid. For yet another, the all-round rehabilitation scheme of the co-operative movement, which the Reserve Bank considers essential, will not be easy of realization in the circumstances, and further, as the Reserve Bank as a Central Bank must maintain absolute liquidity in its position, Professor Niyogi[1] rightly observes that 'the Reserve Bank will hardly be in a position to grant loans

[1] *The Co-operative Movement in Bengal*, p. 140.

against promissory notes of provincial co-operative banks or discount such notes issued for cultivation finance'.

LONG-TERM CREDIT

Long-term finance is required by the agriculturist for the liquidation of past debts and the improvement of land. Such loans are generally given against the security of land, and land-mortgage banks are therefore considered the most suitable agency for providing such finance.

Although the first land-mortgage bank in India was established in 1920 in the Punjab, the first real beginning in land-mortgage banking was made in 1929, with the establishment of the Central Land-Mortgage Bank in Madras for centralizing the issue of debentures and co-ordinating the working of primary banks in that province. A central land-mortgage bank was also organized in Bombay in 1935. By 1939, there were about 100 land-mortgage banks in Madras with a working capital of Rs 83 lakhs, 12 in the Punjab, 13 in Bombay; 12 in the C. P and 5 each in Bengal, the U. P. and Assam.

The technique of land-mortgage banking is most developed in Madras and Bombay, in which provinces the central land-mortgage banks raised large capital by issuing debentures The land-mortgage banks of Bengal and the C. P are financed by the respective provincial co-operative banks.

Although the land-mortgage banks in the various provinces have been registered under the Co-operative Societies Act, they are, strictly speaking, not co-operative organizations They are limited liability institutions of agricultural borrowers, with some non-borrowers for obtaining funds or with business experience Generally, the shareholding of each member is limited, although in some cases members

have to contribute a certain percentage of their borrowing to the share capital.

Loans are given to members on mortgages of their lands up to 50 per cent of the value of land in some provinces, or up to 30 times the land revenue payable on them in others. Generally a maximum limit which varies between five and ten thousand rupees is fixed for loans to be granted to an individual member. The period of loans varies from 15 to 30 years, and the rate of interest from 6 to 9 per cent.

An examination of the working of land-mortgage banks reveals that the banks have been concerned too much with the redemption of old debts, and too little with the improvement of land and agriculture and the introduction of better methods of farming.

In view of the crushing burden of past debts, a pre-occupation with the liquidation of this burden is probably natural and also inevitable. But if the other question of improvement of land and methods of farming is not given adequate attention, the problem of indebtedness itself may become more acute in future and the condition of the ryot deteriorate still further, for unless he can produce more and better crops and thus augment his income, it is doubtful if the ryot will ever be lifted out of his present plight or whether the essential purpose for which long-term loans are given will be fulfilled. A great responsibility, therefore, rests upon the management of the land-mortgage banks to see that the finance that they provide is properly used The banks must also guard against the appearance of overdues, by properly assessing at the very beginning the amount of loan that can be given to an individual member and by insisting upon punctual repayment. For proper and useful functioning of land-mortgage banks, there should be close collaboration and co-ordination between land-mortgage

banks, the Agricultural Department of the Government and the machinery of debt conciliation boards, where they exist

THE RESERVE BANK AND LONG-TERM CREDIT

The Reserve Bank is not statutorily authorized to provide long-term finance It cannot therefore render much effective assistance to land-mortgage banks. Central land-mortgage banks which, however, have been declared to be provincial co-operative banks under the Reserve Bank of India Act, may obtain loans and advances for periods not exceeding 90 days against Government securities in case of an emergency. The Reserve Bank can also help land-mortgage banks by buying their debentures or by making loans against them provided they are guaranteed by Government both in respect of principal and interest and provided they are readily marketable. The principal and interest of debentures issued by the Bombay and Madras Provincial Land-Mortgage Banks are guaranteed by the Governments of Bombay and Madras respectively. But the Reserve Bank may refuse to purchase these debentures on the ground that they are not readily marketable.

CHAPTER XXII

POST-WAR DEVELOPMENTS

MONETARY SUPPLY

THE total supply of money showed a small decline in 1946-47 as compared to 1945-46. This decline is the result of a larger note circulation offset by a proportionately larger fall in the demand deposits of banks and deposits with the Reserve Bank of India. The fall in the rate of expansion of total monetary supply in 1946-47 is primarily due to two factors,—the curtailment in the defence expenditure of the Government of India and in behalf of Allied Governments and a negative balance of payments during the year. The relevant figures of total monetary supply are detailed on p. 263.

The total money supply has been calculated as the total notes in circulation plus the demand deposits of banks (including the Reserve Bank) minus cash reserves of banks (which include their deposits with the Reserve Bank). It includes therefore Government deposits with the Reserve Bank.

MONEY AND PRICES

Contrary to expectations, the price situation in the country worsened during 1946-47. It was hoped that with the cessation of the War and defence expenditure, production of consumer goods as also the importation of such goods would considerably increase and thereby help in lowering the level of prices. In actual fact, wholesale prices increased during 1946-47. The Economic Adviser's

Rupees in crores

	March 1941	March 1942	March 1943	March 1944	March 1945	March 1946	March 1947
1. Notes in Circulation ...	241	382	644	882	1,085	1,219	1,242
2 Demand deposits of banks (scheduled and non-scheduled)	177	232	387	543	624	735	714
3 Deposits with the Reserve Bank of India (excluding deposits of Burma Government) .	59	63	87	167	392	643	562
4 Cash Reserves of banks (scheduled and non-scheduled)	45	51	65	78	120	120	117
5 Money supply (excluding rupee coin, and small coin) (1+2+3−4) ..	432	623	1,053	1,514	1,981	2,477	2,401
6 Circulation of rupee coin ...	...	..	124	137	147	166	168
7 Total money supply (excluding small coin) (5+6)..	..		1,177	1,651	2,128	2,643	2,569
8. Increase in total money supply (including small coin)	85	203	487	505	496	524	−68

index number of wholesale prices in 1946-47 averaged 275.4 as against 244.9 in 1945-46. The figures since 1941-42 are detailed below :

Economic Adviser's Index Number (August 1939 = 100)

	General Index	Food Articles	Industrial Raw Materials
1941-42 ...	137·0	122·1	
1942-43 ...	171·0	174·6	...
1943-44 ...	236·5	263·4	...
1944-45 ...	244 2	232·9	...
1945-46 ...	244 9	237 0	249 8
1946-47 ...	275·4	256·8	316·3

In these figures, it is noteworthy that as compared to 1945-46 the rise in the index of industrial raw materials in 1946-47 is more than twice that of the general index over the same period.

Various factors are responsible for a decline in production and a rise in the general index in 1946-47 over that of the previous year. The main factors are political uncertainty, inadequacy of capital equipment, frequent strikes and labour unrest, Government's taxation measures and the uncertainty of Government's policy in respect of many important controls. Another contributory factor was the increment in wages and allowances which had to be conceded in many cases as a result of demands put forth by labour.

With a view to check inflation, certain measures were introduced. Government continued to encourage small savings. The reduction in defence requirements also enabled them to release larger quantities of essential raw materials and consumer goods for civilian production and consumption. Import restrictions were also considerably relaxed. But all these measures failed to bring prices under control. Again, on September 30, 1946 when the Defence of India Act expired, many war-time controls including the Hoarding and Profiteering (Prevention) Ordinance and the Consumer Goods (Control and Distribution) Order were allowed to lapse. In the resulting circumstances, Government appointed in February 1947 the Commodities Prices Board for the purpose of keeping under review the movements of commodity prices and advising Government in regard to prices of controlled commodities and on the question whether other commodities also should be brought under control. In determining price levels, the Board is expected to take into account such factors as cost of production, current prices in relation to pre-war

price levels and their bearing on other commodities, and also to explore possibilities for a reduction in cost of living. The first list of commodities referred to the Board for examination included food-grains, cotton and cloth, to be followed later by other articles such as iron and steel and cement.

Exchange Control

The basic principles underlying exchange control continue to be what they were during the war. The powers granted under the Financial Provisions of the Defence of India Rules were retained with certain modifications in the Foreign Exchange Regulation Act, 1947. Under this Act, transactions in foreign exchange, as during the war, are confined to banks authorized to deal in foreign currencies on such terms and conditions as laid down by the Reserve Bank, which is the exchange control authority in its capacity as agents of the Government of India. The new Act has imposed an additional restriction by prohibiting transactions with any person resident outside India, even though within the sterling area This, however, has not as yet introduced any change in the exchange control system in actual practice as on the day the Act came into operation the Reserve Bank issued notifications giving general permission for payments within the sterling area.

The Act confers wide powers on the Central Government and the Reserve Bank to control transactions in foreign exchange and securities and the import and export of bullion and currency notes. How this control will be exercised will naturally be determined by the policy of the Government of India. The balance of payments position of the country as also Government's obligation in regard to the

International Monetary Fund will again largely influence this policy.

STERLING DEBT

India's sterling debts which stood at about Rs 469 crores at the outbreak of the war in 1939 was reduced to about 91 crores by March 1943 By March 1947, it further declined to about 59 crores. A total amount of £324 million of sterling debt has been repatriated between April 1937 and March 1947 at the purchase value of £322 million or Rs 430 crores. Of this amount, stocks of the value of Rs 157 crores have been cancelled and rupee counterparts issued in respect of the balance of Rs 273 crores.

The repatriation of sterling debt has undoubtedly been a measure of great benefit to India. She is now a creditor country. To the extent that the liquidation of the sterling debt has not been effected by the creation of rupee counterparts, there has occurred a reduction in the national debt and a saving in interest. Even to the extent that the debt has been transferred from without to within India by creating rupee counterparts, it will mean that the amount paid in interest will remain within the country and augment national wealth. Finally, the pressure which until before the war used to be exercised on our exports to meet the service of 'Home Charges' will be relieved, and we should be placed in a relatively favourable position in the foreign exchange market and in regard to foreign trade.

STERLING ASSETS

The sterling assets of the Reserve Bank increased from Rs 114 crores in December 1939 to Rs 1694 crores in June 1946 In June 1947, they declined by Rs 128 crores to Rs 1566 crores. The huge accumulation of sterling assets

during the war and immediately thereafter was due to the expenditure by the Government of India on behalf of the Allied Governments in this country reinforced by a favourable balance of trade and the system that was adopted for financing these transactions. The decline in sterling assets during 1946-47 has been brought about by a cessation of Government's war expenditure and a reversal in the balance of trade position

The sterling balances constitute about the entire foreign exchange reserve of this country. They have been accumulated at the cost of great privation and hardship borne by the people of this country during the years of the war. India depends on these balances for importing the necessary capital equipment for implementing schemes of economic development aimed at improving her depressingly low standard of living The question of a satisfactory and early settlement of these balances is, therefore, of vital significance to India. Preliminary talks of an exploratory nature have already been initiated between the officers of the Finance Department and the Reserve Bank on the one hand and those of the British Treasury and the Bank of England on the other.

Empire Dollar Pool

In a communique issued in October 1946, the Government of India explained their position in respect of the Empire Dollar Pool and the Post-war Dollar Fund. From the beginning of the war up to March 1946, dollars earned by India amounted to Rs 405 crores and dollars spent over the same period aggregated Rs 240 crores. The net balance in respect of other hard currency countries such as Canada, Switzerland, Sweden and Portugal was 51 crores against India during the same period. The net surplus that

accrued on dollar account to India amounted to Rs 114 crores as up to March 1946, and it dwindled to Rs 92 crores in March 1947. In introducing his Budget for 1944-45, the Finance Member announced that His Majesty's Government had agreed to set aside each year as a special case a part of the dollars accruing from India's export surplus to the U. S. A specifically ear-marked for India's post-war development. A separate Fund known as the Post-war Dollar Fund was set up, to which a sum of $20 million was credited for each of the years 1943-44 and 1944-45. This amount was to be utilised after the cessation of war with Japan for re-stocking and capital expenditure in the U S.A. India's purchases, however, were not limited by the amount in the Fund, for she could draw on the Empire Dollar Pool for all legitimate import of capital goods.

The Finance Member announced in his budget speech for 1947-48 that the dissolution of the Empire Dollar Pool was linked to the over-all final settlement of the issue of sterling balances. This question formed a part of the negotiations with the British delegation for the settlement of sterling balances.

The International Monetary Fund and the International Bank for Reconstruction and Development

Both these institutions were set up during 1946-47. The first meeting of the Board of Governors of both these organizations was held in March 1946 to deal with the necessary procedural steps before they could commence operations.

In September 1946, the Fund notified its members to communicate to it, within thirty days, the par value of their currencies, expressed in gold or U.S. dollars, and

based on the rates of exchange that prevailed sixty days before the Fund Agreement came into effect. The Government of India elicited expert as also public opinion on the appropriate rate for the rupee and finally decided that the existing par value should be maintained, which, based on the rupee-sterling rate of 1*s.* 6*d.* and the sterling/dollar parity of 4.03 dollars per pound, works out to Rs 330.852 per $100. This par value was accepted by the Fund. In fact, the initial par values of all currencies were those which were proposed by members of the Fund, and were based on existing rates of exchange. The Fund recognized that the initial par values that were proposed might later be found to be incompatible with the maintenance of a balanced international payments position at a high level of domestic economic activity, and thus call for necessary adjustment. It was also conceded that steps which might be considered necessary to protect a member from chronic or persistent unemployment arising from pressure on its balance of payments would be recognized among measures necessary to correct a fundamental disequilibrium. The Fund would, however, see that the necessary exchange adjustments were made in an orderly manner and competitive exchange depreciation was avoided

India was called upon to pay to the Fund her subscription of $400 million by 1st March, 1947. The amount had to be paid partly in gold and partly in rupees. Under the rules of the Fund, the gold subscription had to be either 25 per cent of a country's quota or 10 per cent of its net official holdings of gold and U.S. dollars, whichever is less. As the latter was the lower figure, gold of this value was transferred to the Fund Of the rupee subscription, a certain amount was credited to the Fund's account with the Reserve Bank and the balance was paid in the form of

non-negotiable non-interest-bearing promissory notes convertible on demand into rupees by crediting the par value to the account of the Fund The Fund announced that it would be in a position to commence operations and sell currencies of members in accordance with its rules and regulations as from 1st March 1947.

Membership of the International Monetary Fund imposes an obligation on a member to maintain orderly exchange arrangements and to avoid competitive exchange alterations and discriminatory currency practices, to conduct exchange transactions on agreed parity; not to propose a change in the par value of its currency except to correct a fundamental disequilibrium; to make changes in its exchange rate only after consultation with the Fund and subject to the extent of the alteration permitted by the Fund. Section 5 of Article IV lays down that the Fund will raise no objection to a 10 per cent change of the par value of a member's currency and that for a further 10 per cent change, the Fund may concur or not but shall declare its attitude within 72 hours. In return, the Fund's resources will be at the disposal of a member country in amounts based on its quota to tide over *current* deficits. When the currency of any particular country becomes scarce, the Fund will ration the available quantity among members The Fund may require members to furnish such information as may be necessary for its operation. It may be added that membership of the Fund entails no obligations of a permanent character. Withdrawal from the Fund takes effect as soon as the office of the Fund receives intimation of secession.

As a result of India's membership of the International Monetary Fund and the fixing of the par value of the rupee, sterling has ceased to be the sole determinant of the external value of the rupee. The Reserve Bank of India (Second

Amendment) Act, 1947, passed by the Central Assembly in April 1947, repealed sections 40 and 41 of the Reserve Bank of India Act which obliged the Bank to buy and sell sterling without limit at specified rates, and replaced them by a section which requires the Bank to buy and sell foreign exchange at such rates and on such terms as the Central Government may determine from time to time in conformity with its obligations as a member of the Fund

The International Bank for Reconstruction and Development formally commenced business in June 1946 In October 1946, the Legislative Assembly approved the payment of India's subscription to the Bank and also of her continued membership of the Bank and the Fund. Up to June 1947, 20% of the Bank's subscription, that is, $80 million was paid, of which the first instalment of 2% or $8 million was in U.S dollars and the rest in rupees.

The purposes of the Bank are detailed in Article 1 of the Articles of Agreement as follows .

(i) To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peacetime needs and the encouragement of development of productive facilities and resources in less developed countries.

(ii) To promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors ; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions,

finance for productive purposes out of its own capital, funds raised by it and its other resources.

(*iii*) To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living and conditions of labour in their territories.

(*iv*) To arrange the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, will be dealt with first.

(*v*) To conduct its operations with due regard to the effect of international investment on business conditions in the territories of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a wartime to a peacetime economy.

To enable the Bank to function properly, it is essential that it must maintain close co-operation not only with the International Monetary Fund but also with the Economic and Social Council and other specialized agencies of the United Nations. A joint standing committee of the Executive Directors of the Bank with the Executive Directors of the International Monetary Fund has been created to consider matters of common interest. The Secretaries of the Bank and the Fund have also been charged with the responsibility of informing each other of new subjects of mutual interest to be considered by the Executive Directors of

each institution, and they have been authorized to exchange documents pertinent to matters of joint concern.

NEW RUPEE COIN

The Indian Coinage Act of 1906 did not permit the minting of coins higher than eight anna pieces in a metal other than silver The Act was amended in April 1947 so as to permit Government to issue all coins including the rupee in any metal. Pure nickel coins were issued in June 1947 , half and quarter rupee nickel coins were put into circulation earlier.

DEMONITIZATION OF HIGH DENOMINATION NOTES

Notes of a denomination higher than Rs 100 were demonitized under the High Denomination Bank Notes (Demonitization) Ordinance of January 1946. Applications for the exchange of high denomination notes received up to April 26, 1946 were dealt with in terms of the notification of January 26, 1946 under which the Governor and the Deputy-Governor of the Reserve Bank were authorized to allow exchanges up to and inclusive of April 26, 1946. Applications received after this date were considered by the Government of India, the Reserve Bank effecting the exchanges subject to their approval. Out of a total of Rs 143.97 crores of high denomination notes in circulation on 11th January 1946, notes of the value of Rs 134.90 crores were exchanged up to June 30, 1947.

TERMINATION OF JOINT MONETARY ARRANGEMENTS WITH BURMA

In 1942, under the stress of the Japanese war, the Government of Burma as also the Rangoon office of the Reserve Bank were moved to India. The responsibility for Burma

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notes was then transferred from the Reserve Bank to the Government of India along with the assets held by the Bank as cover against these notes. In 1945 when Burma was liberated, currency affairs in Burma were placed in charge of the British Military Administration in Burma. The Reserve Bank reopened its office in Rangoon in August 1945 and was appointed bankers to the British Military Administration. With the termination of the military regime on January 31, 1946, the Government of Burma took over the responsibility for the note issue in Burma, but the Reserve Bank continued to function as the agent of the Government in currency matters and also as bankers to Government and other banks. The currencies of India and Burma, however, continued to be linked together by the facilities for the free exchange of Burmese and British India currency through the Reserve Bank. The Burmese Government decided in June 1946 to sever this currency link and establish an independent currency to be managed by a Currency Board in London as from 1st April 1947. Authority was taken by an Order-in-Council in August 1946 to amend the India and Burma (Burma Monetary Arrangements) Order 1937 with a view to terminating the joint monetary arrangements with India on six months' notice. This notice was served on 1st October 1946, and on its expiration on 31st March 1947, the currency system of Burma was delinked from that of India.

THE MONEY MARKET

Long-term Money Market.—The share and gilt-edged market experienced a boom up to about early August 1946, when a break came and a slump ensued This was followed by a great deal of uncertainty and diffidence in the markets. Many factors contributed towards the sharp rise

in the price of equities and gilt-edged such as the Budget proposals for 1946-47 including the abolition of the Excess Profits Tax, Government's redemption and conversion proposals, liberal accommodation granted by banks for speculative purposes etc. But, as the Report of the Central Board of Directors of the Reserve Bank of India for the year ended June 1947 points out, 'From the second week of August (1946) onwards a decline set in, with the realization that the levels of prices reached were such as Government might be unwilling or unable to sustain, and this trend was accelerated by such factors as the outbreak of communal disturbances in mid-August and the general uncertainty of political situation which followed the disturbances' In Calcutta, there was even a short-lived banking crisis mainly affecting the non-scheduled banks The Reserve Bank Report adds that while this was the immediate cause of the decline, the levels that security prices had attained were the result of a combination of inflationary factors and indicated a vulnerable position. Owing to the general lack of confidence engendered by the political situation, investment demand was lacking and there was some withdrawal of funds from banks necessitating the sale of securities by the latter to replenish their cash reserves. Although this lack of confidence was mainly the product of political developments and could not be counteracted actively through monetary factors, the Reserve Bank supported the market on a substantial scale to help maintain security prices and 'stabilize the banking and financial structure generally at levels which there was a reasonable prospect of holding. This produced a steadying influence on the money market and the banking system'.

Short-term Money Market.—Conditions in the money market during 1946-47, unlike in previous years, were generally more stringent. Another noticeable feature was the return to some extent during 1946-47 to the pre-war pattern of alternating slack and busy seasons. The Reserve Bank rate and the Imperial Bank Hundi rate remained unchanged at 3 per cent during 1946-47. The inter-bank call money rate nominally remained around ½ per cent during the greater part of the year From March to June 1947, a larger supply of loanable funds was reported to be available ; but as the banks were following a cautious policy, there was no marked effect on the call money rate Three-month deposit rate varied between ¾ and 1¼ per cent. The Treasury Bill rate has averaged at a little less than ½ per cent.

PART IV

BANKING PRACTICE AND LAW

CHAPTER XXIII

BANKER AND CUSTOMER

Definition of a Banker

THE term 'bank' or 'banker' has not been clearly defined in either any Indian or English statute. Section 3 of the Negotiable Instruments Act says that 'banker' includes also persons or a corporation or company acting as bankers. Section 2 of the Bills of Exchange Act says that 'banker' includes a body of persons whether incorporated or not who carry on the business of banking. Neither of these definitions is, however, helpful. The most accepted definition of a banker is that given by Dr H. L. Hart in his book, *Law of Banking*: 'A banker is one who in the ordinary course of his business honours cheques drawn upon him by persons from and for whom he receives money on current accounts' The opening of current accounts to be drawn upon by cheques is thus an essential condition of a bank or banker. The definition of a banking company as provided in the Indian Companies Act is, however, not very satisfactory. Section 277-F defines a 'banking company' as a company which carries on as its principal business the accepting of deposits of money on current account or otherwise, subject to withdrawal by cheque, draft or order, notwithstanding that it engages in addition in any one or more of the seventeen forms of business enumerated in that section.

Definition of Customer

There exists as yet no legal definition of a customer. According to a view expressed by Sir John Paget, in order to constitute a customer of a bank, a person has to

satisfy two conditions : (*a*) that there is to be some recognizable course of habit of dealing between him and the bank, and (*b*) that transactions are to be in the nature of regular banking business. The first attribute, commonly referred to as the 'duration theory', is no longer considered to be an essential pre-requisite of a customer In *Commissioners of Taxation vs. English Scottish and Australian Bank*, it was held that, 'the word "customer" signifies a relationship in which duration is not of the essence A person whose money has been accepted by the bank on the footing that the bank undertakes to honour cheques up to the amount standing to his credit is a customer of the bank in the sense of the statute (Bills of Exchange Act) irrespective of whether his connexion is of short or long standing'. This is a decision of the Privy Council and therefore binding upon courts in India. It is, however, necessary that a customer should fulfil the second requirement mentioned by Sir John Paget. In contradistinction to casual services rendered by a banker to persons who have opened no account with him, a customer's dealings with him must be of a banking nature. Thus, if a person occasionally goes to a bank, and buys stamps, gets cheques cashed, or deposits valuables for safe custody, he does not thereby become a customer, as these services are not in the nature of regular banking business. In the case just mentioned, it was also stated, in reference to the definition of a customer, that 'the contrast is not between an *habitué* and a new comer, but between a person for whom the bank performs a casual service, for example, cashing a cheque for a person introduced by one of their customers, and a person who has an account of his own at the bank'. The consensus of opinion appears to be that the opening of a deposit or current account is a necessary condition for a person to become a customer.

THE RELATION BETWEEN A BANKER AND HIS CUSTOMER

1. *A banker is not a mere trustee.*—The relation between a banker and his customer is primarily that of a debtor and a creditor, with the added obligation on the part of the banker to honour the customer's cheques up to the amount of his credit balance on current account, or up to the limit of any overdraft which the banker may have agreed to allow. The banker is neither a trustee of the money left with him, nor an agent responsible for its disposal, unless, of course, he specially undertakes duties which make him both an agent and a trustee for his customer. As stated in *Foley vs. Hill*, money, when paid into a bank, ceases altogether to be the money of the principal. It is at the absolute disposal of the banker to do with as he pleases, subject to his undertaking to repay the amount on demand, or in the case of a deposit account, after stipulated notice has been given. The banker, thus, is not an agent, but only a debtor.
2. *Demand for repayment necessary.*—In *Joachimson vs. Swiss Banking Corporation*, it was decided that the debt due by a banker differs from ordinary commercial debts in one important respect. Whereas in the case of ordinary debts, a request for payment is not necessary before a creditor can take steps to enforce payment, a demand on the bank for repayment is necessary before the debt owing to a customer becomes what is known as 'actually and accruing due', and so recoverable in law. This distinction was probably intended to afford some protection to the customer for, in the absence of

such a condition, a banker could repay the full amount of the customer's credit balance at any time or at any place, and thus summarily close the account without reasonable notice and thereby possibly injure the customer's credit through subsequent dishonouring of his cheques

3. *The Current Account and the Limitation Act.*—The decision in the case of *Joachimson vs Swiss Banking Corporation* has an important bearing on the effect of the Limitation Act on the debt owed by a banker to his customer The Act provides that an action to enforce a simple contract debt must be commenced before the expiration of three years from the time when the right of action first arose The right of action arises on an ordinary debt from the date when the debt is payable, or from the date of the last written acknowledgement of the debt, or of the last payment on account of the principal or interest thereon In the case of a debt due by a banker, therefore, the Limitation Act will not begin to run until the customer has made a specific demand for repayment.

This principle, however, does not apply in the reverse case where the customer is indebted to the bank. Such a debt is recognized as an ordinary debt. And the customer cannot be sued for repayment of a debt if, for three years after the date of any advance, he has not made any acknowledgement of the obligation or repaid any part of what is due, or paid any interest thereon, and the bank has failed to commence proceedings for recovery. But the Act does not prevent a banker from obtaining payment by retaining and realizing any

securities of the debtor which have come into his hands in the ordinary course of business

4. *Appropriation of payments.*—If a customer has several accounts with a bank, he may stipulate that the funds paid in by him are to be placed to the credit of any particular account or accounts, or he may insist that they are to be applied for meeting a particular bill or cheque. If he does this, the banker must appropriate payment as directed by the customer. If no such appropriation is made by the customer, the banker has the right to apply funds paid in to lessen or wipe off any debt owed by his customer including even a statute-barred debt.

In the case of a single current or running account, in the absence of any specific appropriation by the debtor or the creditor, the law appropriates the payment. And according to law, it is the first item on the debit side that is discharged or reduced by the first item on the credit side. This is known as the *Rule in Clayton's case*, which applies only in the case of a current or running account.

This rule is of great importance in its bearing upon the rights of a banker, say, under a guarantee, or against a deceased's estate, or against a partnership whose constitution has changed For example, if an account is allowed to be operated even after a guarantee securing that account has been determined, any payments into the account subsequent to the determination of the guarantee, will reduce the liability of the guarantor, and to that extent the banker's right, against the guarantor will be lost. To safeguard himself against the operation of the

Rule in Clayton's case, a banker usually breaks the account, that is, discontinues the old account and opens a new one and informs the customer of the new arrangement.

5. *Banker's obligation to pay Customer's cheques*.—It is one of the primary obligations of a banker to honour his customer's cheques to the extent of the customer's balance on current account or up to the amount of an agreed limit if an overdraft has been granted, provided that the cheques are presented within a reasonable time after their dates of issue. There is no legal definition of what constitutes reasonable time within which cheques should be presented for payment. In India, by custom, a cheque presented six months after its date of issue is considered a stale one. The banker should have reasonable time for crediting amounts before they can be drawn against. Thus, he is not bound to credit to a customer's account cheques and drafts before they are realized, or at least honour his customer's cheques drawn against cheques and drafts deposited by the customer into his account, before the latter are realized. If a banker should without cause or justification dishonour a customer's cheques he would be liable to compensate the customer for injury to his credit (*Marzetti vs. Williams*).

6. *The Banker's Right of Set-Off*.—As a general rule, a debtor is entitled at law to 'set-off' against the debt which he owes any amount which is due to him by the creditor, that is, he may combine the credit and the debit in order to determine his net liability, provided that the debts are both sums

certain, due as between the same parties in the same right, and provided also that there is no express or implied agreement or understanding to the contrary.

If, therefore, a customer has two accounts in the same right, one in credit and the other in debit, then unless there is an agreement, earmarking, or a course of business indicating an obligation to keep the accounts separate, a banker is entitled, on giving reasonable notice to the customer, to set-off any credit balance against any debit balance and to combine the accounts in order to determine the net liability of the customer to the bank.

At one time it was thought that two such accounts could be combined at any time, without giving notice to the customer—a principle which was upheld in the case of *Garnett vs. McKewan.* Now, however, a banker who, in consequence of having combined a credit balance with an overdraft, dishonours his customer's cheques without reasonable notice, will probably render himself liable to an action for damaging the customer's credit, and one judge has gone so far as to suggest that the customer's consent must be obtained before two separate accounts can be combined. The giving of notice does not, of course, necessarily mean that the customer's consent is obtained.

The necessity for giving notice does not arise if the customer's account is stopped by his death, bankruptcy, or insanity, or by the service of a garnishee order, for then the banker may at once combine the accounts in order to determine the net liability of the customer's estate to the bank.

It is extremely important to observe that only accounts in the same right can be combined. But an account, the heading of which indicates that it is a trust or agency account, for example, a Football Club account cannot in any circumstances be the subject or be set off against any other account of the same customer (unless there should be two of such accounts in the same right).

For similar reasons, a banker cannot claim to set off a partner's credit balance against a debt due by his firm, or *vice versa*. Nor can he combine the private account of a customer with an account upon which the customer appears as one of the parties, nor a debit or credit balance on the account of a deceased customer against a credit or debit balance standing in the names of his executors or administrators.

7. *Banker's lien*.—In *Brandao vs. Barnett*, it was stated that 'bankers most undoubtedly have a general lien on all securities deposited with them as bankers by a customer, unless there be an express contract or circumstance that shows an implied contract inconsistent with a lien'. A banker's lien is also an implied pledge, which not only entitles him to retain, but also to realize securities of his customer in case of default after due notice has been given. The right of lien will be excluded if the securities come into the banker's hands in any capacity other than that of a banker, and also if there is an express or implied contract negativing the lien. Thus, no lien arises in respect of documents or valuables left inadvertently with the banker, or of securities placed in his hands with

the object of covering an advance which is not granted, or deposited with him for a special purpose only.

A banker's lien is mainly important in connexion with negotiable securities which come into his hands, usually for collection, in the ordinary course of business, such as cheques, bills, notes, bearer bonds and share warrants to bearer.

8. *A Banker's duty of secrecy.*—A banker is bound not to disclose the state of his customer's account 'except upon reasonable and proper occasion' (*Hardy vs. Veasy*), or by an order of the Court. In *Tournier vs. National Provincial Bank*, four reasonable and proper occasions were mentioned, when disclosure by a banker was considered permissible :

(*a*) where there is compulsion of the law ;

(b) where there is a duty to the public to disclose, for example, if a banker should know that his customer is guilty of an offence such as trading with the enemy during war ;

(*c*) where interests of the bank require disclosure, as in an action against a customer for an amount due ,

(*d*) where disclosure is made with the express or implied consent of his customer.

The practice among banks of giving each other 'confidential opinion' concerning the credit and standing of customers is so prevalent that a banker would probably be enabled to claim that, when a customer opens his account, he gives his implied consent to this practice. If such opinion is given honestly and without malice, a banker will have an

absolute defence on the ground of privilege.

9. *Garnishee order.*—A garnishee order is an order of the Court, obtained by a judgement creditor, attaching funds in the hands of a third party who owes judgement debtor money, and warning the third party (the garnishee) not to release the money attached until directed by the Court to do so. The garnishee should not pay over any funds until an order *nisi* (which means unless) is made *absolute*, as it is only payment under the latter which gives the garnishee an effective discharge against the judgement debtor

A garnishee order attaches debts due or accruing due. The following debts are attachable, namely :

(*a*) deposit account repayable on demand ;

(*b*) deposit account repayable on fixed notice which has been given ;

(*c*) deposit account repayable at a fixed future date or after the lapse of a specified time.

A garnishee order *nisi* gives the judgement-creditor an equitable charge upon debt ; when the order is made absolute, he can realize the charge.

A garnishee order binds the whole of the balance standing to the credit of the customer's account (including uncleared cheques paid to credit as cash) at the time the order is served, even though the balance is more than sufficient to satisfy the garnishee order ; and until the order is withdrawn, no further cheques can be paid out of the account—not even cheques issued prior to the service of the order on the bank. The banker should inform the customer after receipt of the garnishee order and return cheques as 'account attached'.

Money paid into credit after the service of the garnishee order is not attached. Therefore the order has no effect on an overdrawn account. But it is better for a banker to open a fresh account after receipt of the garnishee order.

In respect of a *joint account*, a garnishee order against one of the parties does not attach the balance on such a joint account.

10. *Closing an account*.—This phrase is used to denote the final severance of relation between the banker and his customer by the withdrawal of the customer's balance in the banker's hands, either on the initiative of the customer or at the request of the banker.

A customer may at any time close his current account with a bank by withdrawing the balance if the account is in credit, or by paying the banker his dues, if the account is overdrawn.

A banker is not entitled to close an account summarily without giving such reasonable notice as will obviate any damage to his customer's credit. The correct procedure is to advise the customer in writing that no further credits to his account will be accepted and that he should withdraw any balance standing to his credit, subject to his leaving with the banker sufficient money to pay outstanding cheques.

A banker is bound to stop an account in the event of (*a*) the death, insanity or bankruptcy of a customer, or, in the case of a limited company, the notice of voluntary liquidation or of the making of a winding-up order; (*b*) the service of a garnishee or other order

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of the Court; and (c) notice of an asssignment to a third party of the balance standing in the customer's favour.

11. *Charges.*—A banker is entitled to charge interest on loans, either by express agreement or by right of custom. Further, owing to the practice of bankers of adding the interest to the principal debt every half year, the banker is enabled to charge compound interest The banker also usually charges by custom an incidental charge on unremunerative accounts. The charge is small and varies from one bank to another.

12. *The Pass Book.*—The pass book, or passage book as it was formerly called, is given by a banker to his customer, and is for the purpose of showing the exact state of the customer's account with the banker. The real effect of entries in the pass book has not yet been satisfactorily determined. Sir John Paget contended that the proper function of a pass book 'is to constitute a conclusive, unquestionable, record of the transactions between banker and customer, and it should be recognized as such'. In actual fact, the position is very far removed from this. In the U. S. A., the position from the banker's standpoint is more satisfactory as a duty has been imposed upon the customer to examine his pass book In *Morgan vs. United States Mortgage and Trust Co*, it was decided that 'the depositor who sends his pass book to be written up and receives it back with his paid cheques as vouchers is bound to examine the pass book and vouchers and to report to the bank without unreasonable delay any errors which may be discovered'.

Entries from the Customer's Standpoint.—An entry in a pass book in favour of a customer is *prima facie* evidence against the banker, but is not conclusive evidence, and the banker is not therefore debarred from endeavouring to prove that any entry is an erroneous one. Where an entry showing a payment to a customer's credit has been made in a pass book in error, and the customer, relying upon that credit, has drawn cheques against it or in some other way altered his position, the banker will be bound by that entry. But if the customer's position has not been altered by the entry, the banker is at liberty to show that the entry was made by mistake. In *Akrokerri Mines Ltd. vs. Economic Bank*, it was held that 'the pass book . . belongs to the customer and the entries made in it by the bank are statements on which the customer is entitled to act'.

Since it is essential that the customer should establish his *bona fides* in taking advantage of a wrong entry, it would not be easy, as a general rule, for an ordinary business man to establish his case. But the position may be different in the case of a private individual, who may be honestly misled by wrong entries in the pass book.

Entries from the Banker's Standpoint.—The conflict in legal opinion is so marked that it is impossible to give any clear exposition of the effect of pass book entries in the banker's favour. All that can be said from cases decided in English courts is that before a customer can be estopped from denying the accuracy of his pass book entries, he must have been guilty of such negligence as to cause the banker's position to be detrimentally affected, or the customer must have acted in such a manner as to indicate that he had treated the account as a definitely settled account. It remains to consider what constitutes a suffi-

cient degree of negligence, and what amounts to a settled account. In *Chatterton vs. London & County Bank*, it was held that a banker had no right to infer that a customer had even looked at his pass book, though the pass book had been received by him, items ticked off, and the pass book returned without comment to the banker. If this view is correct, the question of contributory negligence on the customer's part can hardly arise.

The point as to what can be considered a settled account was raised in *Vagliano Bros. vs. Bank of England*, but no satisfactory conclusion was reached, though the trend of the judgement seemed to indicate that the passing to and fro of a pass book did imply some sort of a duty on the part of the customer to examine it ; but it was not considered that the examination of an account by the customer and the return of the pass book was conclusive evidence of a settled account and that thereby the customer would be estopped from disputing the accuracy of the entries

In no case is the banker justified in withholding from his customer any amount received for his credit, but omitted to be shown in the pass book, on the plea of acquiescence on the part of the customer.

agent, including an infant and an undischarged bankrupt.

Minors or Infants.—Under the Indian law, a person is a minor until he completes his eighteenth year, unless, before he is eighteen, a guardian of his person or property is appointed by court, in which case minority extends up to the age of twenty-one. Under the English law, all persons below the age of twenty-one are minors or infants.

A banker may, without risk, allow an infant to open an account and draw cheques upon it so long as it is in credit. The account, however, should not be allowed to be overdrawn; for money lent to an infant cannot be recovered, even if he has given a security.

As a general rule, a minor can repudiate all his contracts at his option. Thus, if an advance is given to an infant, the transaction is void and the banker will be unable to succeed in an action for repayment of the money, or to retain or realize any securities deposited by a minor in respect of the advance. If a third party should have given a guarantee or deposited a security for an advance given to a minor, the banker will be able to enforce his rights against the third party.

Sometimes bankers, instead of opening accounts in the names of minors, do so in the names of parents and guardians, marking the accounts so clearly as to indicate that they concern minors.

An infant can act as an agent and bind a principal, so that a banker is safe in accepting a written authority empowering an infant to draw or indorse cheques and bills or to overdraw his principal's account. An infant may also act as a partner in a firm with power to bind his co-partners, but it is not desirable to allow an infant to operate a partnership account unless specific authority is obtained from the other partners.

Married women.—Current accounts may be opened in the name of a married woman, for she has power to draw cheques and give sufficient discharge. She can make contracts, and sue or be sued upon them, but the person suing her, for example, a banker who has given her an advance, has no personal remedy against her in respect of the advance, but only a remedy against her separate property. A banker should, however, be careful in giving her any loan or advance, for even if she has separate property—or *stri-dhan* as it is known among Hindus—the property can be settled on her in such a way that she may only use the income, and not touch the corpus nor anticipate the income.

If a married woman incurs debts, she cannot make her husband responsible for them unless she acts as his agent, or borrows for her necessaries or the necessaries of the household.

Joint Accounts.—Current accounts may be opened in the name of two or more persons who are not partners. The banker should take a mandate signed by the persons opening a joint account embodying instructions how the account is to be operated, how cheques and bills are to be endorsed and signed, and clearly setting forth how the balance is to be disposed of in the event of the death of any of the parties.

Unless the parties specially delegate their authority to sign cheques to one or some of them, all cheques, bills and other instructions must be signed by all the parties. On the death of any party to a joint account, the balance vests in the survivor or survivors, but such survivor or survivors is or are in the position of trustees with regard to any portion of the funds which properly belong to the deceased's estate;

and it will therefore save trouble to the banker to have the matter clearly stated in the mandate.

The banker should also obtain an undertaking from all the parties to be jointly and severally responsible for any overdraft. This is essential, for in the absence of such an undertaking, the parties will only be liable jointly, that is, on the death of one of the parties, his estate will be freed from liability, and only the survivor or survivors will be responsible for the repayment of the advance.

Bankrupts.—As soon as a banker gets an intimation that his customer has suspended or intends to suspend payment to his creditors, or has filed in court a declaration to the effect that he is unable to pay his debts, he should stop all business transactions with such a customer. The whole of a bankrupt's property vests in the Official Receiver, or the Official Assignee in Presidency towns, who administers it for the benefit of the general body of creditors.

Special care should be taken in the case of undischarged bankrupts who are subject to a number of disabilities. The important among these are (*a*) that the property of a bankrupt is *prima facie* vested in his trustee ; (*b*) that he cannot obtain credit for more than fifty rupees ; and (*c*) that a banker must not conduct an account for a person whom he knows to be an undischarged bankrupt without due intimation to the Official Receiver or the Official Assignee.

All transactions with an undischarged bankrupt in respect of property, real or personal, acquired after adjudication, if completed before any intervention by the trustee, shall be valid against the trustee. The risk of opening an account with an undischarged bankrupt is, however, great inasmuch as it may not be easy to find out what is and what is not after-acquired property.

Partnerships.—'A partnership,' according to Section 4 of the Indian Partnership Act, 'is the relation between persons who have agreed to share the profits of the business, carried on by all or any of them acting for all'. In the past, a partnership had to observe no formalities, such as registration. Since the putting into effect of Sec. 58 of the Indian Partnership Act, 1932, partnerships can now be registered so that persons dealing with them may now secure information about the composition of such partnerships.

Every partner has implied power to bind the firm by opening an account in its name and by drawing, indorsing or accepting bills of exchange, except as to any person who has notice that a partner is restricted from so acting. A banker may, therefore, open an account in the name of a partnership firm on receiving an application from any one partner. Yet no banker should open an account in the name of a firm consisting of several persons, or pay cheques or honour other instruments bearing the signature of one partner, without taking a mandate, signed by all the partners authorizing the opening of the account and specifying the manner of operating thereon. As a rule, the mandate will also contain an undertaking by all the partners to hold themselves *jointly and severally liable for any overdraft or* loan granted to the firm. All partners must also sign any document charging the property of the partnership as security for any loan or overdraft granted to the firm.

A banker should not open an account on behalf of a firm in the name of a partner without proper enquiry. Sec. 19(2) (b) of the Partnership Act says that, in the absence of any usage or custom to the contrary, the implied authority of a partner does not empower him to open a banking account on behalf of the firm in his own name. It

is expedient, therefore, that a banker should always open a firm's account in the firm's name.

A banker should not accept any cheque payable to the firm for credit to the private account of a partner without the permission of the other partners. He is not, however, necessarily put on inquiry if a partner draws a cheque in his favour on his firm's account and sends it for the credit of his personal account.

In the event of the retirement of one or more partners, the liability of such persons ceases in so far as future transactions are concerned. If, however, no notice of such retirement is given, the retiring partner or partners will continue to be liable for advances made even after retirement. Sec. 32(3) of the Partnership Act says that 'notwithstanding the retirement of a partner from a firm, he and the partners continue to be liable as partners to third parties for any act done by any of them which would have been an act of the firm if done before the retirement, until public notice is given of the retirement ; provided that a retired partner is not liable to any third party who deals with the firm without knowing that he was a partner' On the retirement of a partner, if the banker does not like to relinquish his claim against the retiring partner in respect of advances made to the firm, he will close the old account and open a new one so as to avoid the *Rule in Clayton's* case. The banker will adopt the same procedure on the dissolution, from whatever cause it may be, of a partnership firm.

Trading Companies.—In opening an account in the name of a trading company or corporation, a banker should ask for a copy of the resolution, passed by the Board of Directors, appointing him as banker to the company and naming the person or persons authorized to operate the

account. Along with the resolution, the banker is supplied with the certificate of incorporation and of commencement of business for inspection and return, a copy of the Memorandum and Articles of Association and a copy of the company's last balance-sheet, certified by the auditor.

The banker should carefully read the copies of the Memorandum and Articles of Association so as to ascertain the nature of the business of the company as well as the extent of the powers of the company and of its directors. The Articles are subsidiary to the Memorandum, but in the Articles are detailed the rights vested in the directors to exercise the powers of the company as defined in the Memorandum. The banker should particularly notice the regulations governing the execution and indorsement of contracts, deeds, bills of exchange, promissory notes and cheques, ascertain how the banking account is to be conducted, whether or not all acts of the directors must be done at a Board meeting, and whether directors can delegate authority, and if so, to what extent.

A trading company has implied borrowing powers for the carrying out of the legal objects of the company, even if these powers are not explicitly mentioned in the Memorandum. Usually, however, borrowing powers, with or without restrictions, are specified in the Memorandum and the Articles of Association A banker should not, however, grant a company an advance without first requiring the deposit of a certified copy of the resolution of the directors authorizing the overdraft and sanctioning the deposit and the signing of the proposed security. He should also examine whether such a resolution and the terms thereof are permissible under the Memorandum and the Articles of Association. It is considered advisable that the board of directors should pass a resolution on each occasion the com-

pany wishes to borrow. A banker is not required to make enquiries as to the purpose for which funds are being borrowed, and the advance made cannot be avoided on the ground of the funds being misapplied, as long as the banker acts *bona fide* and without knowledge of the misapplication.

Non-Trading Companies.—These are institutions or associations formed under the Indian Companies Act with a view to promote some object such as art, science or religion, provided any profits made are not distributed by way of dividends to members. In opening accounts of such non-trading companies, all the formalities as described in connexion with trading companies have to be observed, except that they are not required to produce a certificate of commencement of business. If an advance is wanted by a non-trading company, the banker should examine the powers of borrowing and any limitation that may have been imposed upon their exercise in the Memorandum and Articles of Association.

The Banker and the Customer's Account.—In opening a customer's account and allowing him to operate it, the banker should be particularly careful in two matters. Firstly, he should not open an account without obtaining satisfactory references about the customer. Secondly, he should be particularly careful in granting advances. If proper references have been taken before the account is opened and so long as it remains in credit, the banker runs practically no risk. Before, however, an advance is granted, the banker must satisfy himself as to the borrowing power of his customer, the nature of the securities offered and the legal means available to him for realizing the securities, in case of default.

CHAPTER XXV

BILLS OF EXCHANGE

THE term 'bill of exchange' also expresses its meaning. It is a 'bill' which can be 'exchanged', that is, it is a written expression of a debt which can be passed from hand to hand and carry with it the right to demand payment of the debt

A 'bill of exchange' is defined in Section 5 of the Negotiable Instruments Act as 'an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument'.

BILL AND PROMISSORY NOTE

The definition of a bill of exchange is very similar to that of a promissory note, but differs in the following particulars. In the first place, there are in a bill three parties : (*a*) the drawer or maker of the bill, (*b*) the drawee to whom it is addressed and, if he accepts it, the acceptor, and (*c*) the payee, in whose favour it is drawn. In a promissory note, however, there are only two persons, the promisor and the payee, but no drawee In a bill of exchange, it is not necessary that the three persons should be three separate individuals. One person may become drawer and payee, or drawee and payee, or drawer and drawee. Where drawer and drawee of a bill are the same persons, the instrument is still a bill of exchange. It is only necessary that the three parties must be mentioned in the bill with

certainty. Although the promissory note in its original shape bears no resemblance to a bill, yet when it is indorsed it is similar to a bill, for then it is an order by the indorser of the note upon the maker to pay the indorsee. In the second place, in a bill there is an unconditional *order* to pay, while in a promissory note, there is an unconditional *promise*.

ESSENTIALS OF A BILL

As its definition implies, a bill must satisfy three important conditions. In the first place, the order to pay must be unconditional. An order to pay is, however, not 'conditional' by reason of the time for payment of the amount or of any instalment thereof being expressed to be on the lapse of a certain period after the occurrence of a specified event which, according to the ordinary expectation of mankind, is certain to happen, although the time of its happening may be uncertain. A bill payable out of a particular fund is not unconditional, and therefore, invalid, because it is not certain whether the fund will be in existence or prove sufficient when the bill becomes payable, but an unqualified order to pay coupled with an indication of the fund out of which the drawee is to reimburse himself or of a particular account to be debited with the amount is *unconditional*. Thus, an order to pay 'out of the sale proceeds of a piece of land' is invalid, but an order 'to pay Rs 1,000 to C' out of account No. II is valid.

In the second place, the sum to be paid must be an amount certain. The Negotiable Instruments Act, however, says that the sum payable is certain, although it may include future interest or be payable at an indicated rate of exchange, or be according to the course of exchange, and although the instrument may provide that, on default of

payment of an instalment, the balance unpaid shall become due.

In the third place, the individual to whom direction given for payment, or to whom payment is to be made must be a person certain. A person will, however, be a 'certain person', even though he may be misnamed or designated by description only.

A bill, it should be noted, is not invalid by reason (*a*) that it is not dated, (*b*) that it does not specify the value given, or that any value has been given for it, or (*c*) that it does not specify the place where it is drawn or the place where it is payable. Where a bill expressed to be payable at a fixed period after a date is issued undated, or where the acceptance of a bill payable at a fixed period after sight is undated, the holder may insert the true date of issue or acceptance, and the bill is payable according to the date so inserted.

Negotiation of a Bill

The negotiation of a bill commences only on the issue or delivery of it to a person other than the drawer or drawee. If the bill is payable to the drawee or his order, he must indorse it ; but mere indorsement does not legally constitute negotiation, which commences only with the transfer and/or delivery of the bill by the third party to another. The principle of negotiation is that the property in and rights connected with the instrument are passed to another person, and delivery of the instrument, either actual or constructive, is essential.

Once any person having a legal right to enter into a contract has signed his name on a bill and made delivery of it to another person, he becomes liable for the eventual full payment of the bill. Persons who indorse the bill

become liable in the order in which they have indorsed the bill But each party has a right to proceed against any or all prior parties, and is not obliged to ask for payment only from the acceptor or the person immediately preceding him If any party pays the bill, it entitles him to have it delivered to him, and he then acquires all the rights it carries against prior parties

Time of Payment

The order for the payment of a bill must be made out in such a way that the date of payment can be definitely ascertained. The date must be actually fixed or be capable of being computed from the date of an event which is bound to happen. Thus, a bill payable at a certain period after the death of a person then living is valid ; but a bill so payable after the marriage of a person is not valid, as this is an event which is not necessarily bound to happen.

In respect of the date of payment, there are two classes of bill, those payable on demand, and those payable at a fixed or determinable future time. *Demand bills* are those which are expressed to be payable on demand, or at sight, or on presentation, or in which no time for payment is expressed. These bills become due for payment as soon as demand for payment is made. These bills carry no days of grace.

The second category of bills is known as *time bills*. In a few cases, time bills may be drawn payable on stated dates, after which the word 'fixed' is added, and they then become due and payable on the stated dates. Usually, these bills are subject to a slight extension of time which consists of three extra days known as 'days of grace'. There is no limit to the length of time for which a time bill may be drawn. In the case of bills payable after sight, the time

begins to run from the date of acceptance or if the bill is dishonoured, from the date of noting or protesting for dishonour. When a bill is dishonoured by non-acceptance or non-payment, it will be presented by a Notary Public who, if acceptance or payment, as the case may be, is refused, will attach a slip to the bill stating the date of presentation, the answer given, the Notary's charges and his initials. This is known as 'noting' the bill. At any time once the bill has been noted, a legal document is drawn up by the Notary and is known as a 'protest'

Title to a Bill

Any person in possession of a bill is a *possessor*, but his legal rights will vary according to the conditions under which the bill is possessed. He may be a wrongful possessor, or a bearer, or a holder either for value or in due course, or a wrongful holder.

A wrongful possessor is a person who has in possession a bill affected by forgery. He has no rights under the bill.

The bearer of a bill is a person who acquires a title to a bill transferred to him by delivery only. A bill payable to bearer or indorsed in blank is a bearer bill, and can be negotiated by simple delivery. Since a transferor by delivery does not sign his name on the bill, the transferee or any subsequent holder has no right against him even for consideration. But the transferor by delivery will be liable for any defective title of the bill inasmuch as he warrants to any transferee who gives value for the bill that the instrument is what it purports to be, and that he has a right to transfer it. If this is not so, as, for example, when a forged signature appears on the bill, the transferee can sue the transferor for breach of warranty.

The holder of a bill is the payee or indorsee of a bill who is in possession of it, or the bearer of a bill payable to bearer. A simple holder need not have given value for the bill, and his title to it depends on whether any defect exists in it or not. A defect in the bill exists if the acceptance, issue or subsequent negotiation of the bill is affected with fraud, duress or illegality.

A holder for value is the holder of a bill for which value has at any time been given, and it is not essential that he should himself have given value. His title depends upon the same grounds as those of a simple holder except that lack of consideration cannot be set up against him save by his immediate transferor if in fact he had not given value. A holder for value may be an agent for collection, or have had the bill transferred to him by way of gift, but he can sue in his own name. Where a holder of a bill has a lien on it, as in the case of a bill pledged to a bank as security, he is deemed to be a holder for value to the extent of his security.

A holder in due course is a holder of the highest order. He is a holder who became such for consideration before its maturity and without sufficient cause to believe that any defect existed in the title of the person from whom he derived his title. A holder in due course must satisfy the following conditions :

(*a*) that he is a holder, that is, he must be in possession of the bill if it is payable to bearer or he must be the payee or indorsee, if it is payable to or to the order of the payee, and the making of the instrument has been completed by delivery to the payee or the indorsee. He must be entitled to sue in his own name on the instrument ;

(*b*) that he became holder before the amount mentioned in the bill became payable, that is, before the maturity of the bill;

(*c*) that he became holder for consideration. While a holder for value need not himself have given value for the bill, the holder in due course must have done so;

(*d*) that he became the holder without having sufficient cause to believe that any defect existed in the title of the person from whom he received it.

Forgery of an instrument is placed on a different footing from defects in title. A forged bill is no instrument in law. Forgery connotes not a defect in title, but an absence of it. Thus, nobody can become a holder in due course of a forged instrument as it is a nullity at law, although in exceptional cases, certain holders like banks are given special statutory protection against forgery of indorsements, namely, in respect of crossed cheques.

CHAPTER XXVI

CHEQUES

A CHEQUE is defined by Section 6 of the Negotiable Instruments Act as 'a bill of exchange drawn on a banker and not expressed to be payable otherwise than on demand'. Combining this definition with that of a bill of exchange, we may say 'a cheque is an unconditional order in writing addressed by one person to another, who must be a banker, signed by the person giving it, requiring the banker to whom it is addressed to pay on demand a sum certain in money to or to the order of a specified person or to bearer'.

The essential conditions that an instrument to be rightly called a cheque should fulfil are :

(*a*) it must be an instrument in writing, the writing may be done by any means. But writing in pencil may be sent back for confirmation, as chances of fraud are greater ;

(*b*) it must be an unconditional order to pay. If, for example, a cheque has a receipt form attached to it with the following words, 'provided the receipt form at foot is duly signed and dated', the order is not unconditional. But if the instruction is addressed to the payee, and not the banker, then the order is unconditional ;

(*c*) it must be signed by the person giving it. The signature may be by the drawer himself or by some person duly authorized by him. The signature may also be in a trade or assumed

name, but the person so signing is liable as if he had signed the instrument in his own name;

(d) it must be drawn upon a banker. Thus, instruments containing orders for payment drawn upon, say, Government Treasuries, such as, supply bills, are not cheques. Drafts drawn by one office or branch of a bank upon any of its other offices or branches are cheques ;

(*e*) it must be for the payment of a certain sum of money only. The sum payable is certain, although it may include interest at a given rate up to the happening of a specified event, or drawn in foreign currency and payable at an indicated rate of exchange or according to the course of exchange. The amount of the cheque is usually stated both in figures and words. If the two differ, the amount expressed in words may be legally paid. But it is the practice of bankers to return such cheques with the remarks, 'words and figures differ' ;

(*f*) it must be payable to or to the order of a specified person or bearer. A person in law is not necessarily a human being. It may be a body corporate or a functionary such as a Secretary or a Manager. Cheques are sometimes made payable to fictitious persons, for example, when drawn as 'Pay Wages' or 'Pay Cash', and are then treated as payable to bearer ;

(g) the sum mentioned in it must be payable on demand.

THE CHEQUE AND THE BILL OF EXCHANGE

A cheque is similar to a bill of exchange except in the following respects:

(*a*) it is supposed to be drawn on funds in the hands of a banker. A cheque is, however, a mere order to pay, which the banker may or may not accept, subject to all the legal consequences in case of wrongful dishonour.

(*b*) it requires no acceptance;

(c) the drawer of a cheque is not discharged by failure of the holder to present it in due time unless the drawer has sustained damage by the delay;

(*d*) when a cheque is not met, notice of dishonour is not necessary as in the case of bills. The lack of funds in the hands of the banker is sufficient notice;

(*e*) a cheque is a revocable mandate, and the authority may be revoked by countermand of payment and is determined by notice of the customer's death or bankruptcy;

(*f*) a cheque may be crossed.

Dating.—A cheque is not invalid by reason only that it is ante-dated or post-dated. Further, a cheque not dated is valid, and any holder may insert a date. If a cheque is post-dated, it is really not a cheque at the moment, as it is not an instrument payable on demand, and, as such, resembles a bill, but if it is presented for payment on or after its due date, the paying banker should have no objection to paying it. Further, the negotiability of such a cheque is not imparied merely because it is post-dated. A banker will, however, lose his statutory protection if he

pays a cheque before it is due for payment, and must bear any loss that may arise out of his action.

Stale or Overdue Cheques.—There is no precise legal indication as to when a cheque is to be considered stale or overdue. Under the English law, a bill or a cheque becomes overdue for purposes of negotiation when it appears on the face of it to have been in circulation for an unreasonable length of time. As to what constitutes an unreasonable length of time is a question of fact to be determined by the circumstances of each case. There is, however, no provision in the Negotiable Instruments Act when a demand instrument is to be considered overdue. In England, a cheque is considered to be in circulation for an unreasonable length of time from the point of view of its negotiability after the lapse of about ten days or so from its date of issue In India, it is the usual practice of bankers to regard a cheque as overdue after the lapse of six months from the date of issue.

Material Alterations.—Any material alteration in a cheque must be made with the drawer's assent, evidenced by his signature or initials. The full signature is preferable to initials, as initials may be more easily forged. If there are two or more signatures to a cheque, all must join in confirmation.

Material alterations include alterations in respect of date, sum payable, place of payment, the name of payee and crossing. An 'order' cheque may be converted into a 'bearer' one by substituting the word 'bearer' for 'order' by drawer only and by confirming such substitution by his signature. But any holder may alter a bearer cheque to an order cheque without the drawer's verification.

If a banker should pay a cheque which has been materially altered without the drawer's confirmation, he will do

so at his own risk.

Lost Cheques.—If a cheque is lost, the holder may compel the drawer to give him another cheque in identical terms by providing to the drawer an indemnity against any claims of third parties should the lost cheque be found again. The drawer should not issue a duplicate cheque without proper indemnity, for if the cheque is negotiable, and the finder transfers it to another person who honestly takes it for value, the transferee can compel payment from the drawer, in which case the latter will have to pay twice over.

Immediately a cheque is lost, the loser should notify the fact to all the parties to the cheque, and also request the drawer to give notice to the drawee-banker to stop its payment

Loss of Cheque sent through the Post.—The Post Office is not liable for any such loss as it accepts no responsibility for unregistered letters. The responsibility for such loss rests, therefore, on the sender or the addressee. As the Post Office is *prima facie* the agent of the sender, he must assume the risk of his remittance not arriving properly at its destination. But if the creditor should have definitely said, for example, 'Please send me a cheque by post', then the Post Office becomes the agent of the creditor, who will be liable for loss of the cheque in transit. It is advisable for the safety of the parties concerned that cheques sent by unregistered post should be *specially* crossed.

Crossed Cheques

Sections 123 and 124 of the Negotiable Instruments Act define crossed cheques as follows:

Section 123.—Where a cheque bears across its face an addition of the words 'and Company'

or any abbreviation thereof, between two parallel transverse lines, or of two parallel transverse lines simply, either with or without the words 'not negotiable', that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed generally.

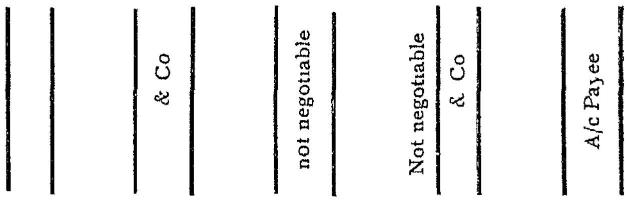
Section 124.—Where a cheque bears across its face an addition of the name of a banker, either with or without the words 'not negotiable', that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed *specially*, and to be crossed to that banker.

General and Special Crossing.—From these definitions, it will be seen that there are two distinct types of crossing: (*a*) general and (*b*) special. A general crossing must include two parallel transverse lines written, printed, stamped, or perforated across the face of a cheque and these lines may be accompanied by any such additions as the words '& Co.', 'and company', 'not negotiable', 'account payee', 'account A.B.C.', 'under or not over . . . . rupees' etc These additional words have certain effects, but they are not an essential part of the crossing, nor do they constitute a crossing by themselves in the absence of the transverse lines.

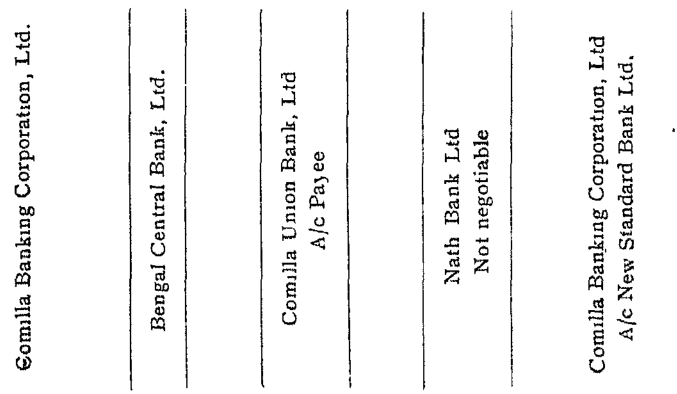
The name of a banker written, stamped, printed or perforated across the face of a cheque forms a special crossing, whether it appears alone or with transverse lines, or with or without any of the additional words mentioned above.

Different Forms of Crossing.—The following are some

specimens of general crossing :



The following are some specimens of special crossing :



Effect of Crossing.—Unless the words 'not negotiable' appear along with the crossing, a general or special crossing has no effect whatsoever on the full negotiability of a cheque as between different holders. The effect of a general crossing, in so far as it concerns a banker on whom it is drawn, is that he is safe only if he pays the cheque to another banker. The effect of a special crossing is that the banker must pay it only to the banker named in the crossing, or acting as the agent of another banker. The effect of a crossing applies equally to a bearer and an order cheque. A

crossed cheque payable to a bearer disposes of the necessity for indorsement only.

'Not Negotiable' Crossing.—Section 130 of the Negotiable Instruments Act says, 'A person taking a cheque crossed generally or specially, bearing in either case the words "not negotiable" shall not have, and shall not be capable of giving a better title to the cheque than that which the person from whom he took it had'. A 'not negotiable' crossing does *not* make the cheque not transferable, but takes away from it the special feature of negotiability If a person takes such a cheque which has been stolen or lost, he cannot enforce payment of the instrument, nor can he retain any money paid to him upon it as against the true owner, however honestly he may have acted and even though he had not been aware of the fact that the cheque was stolen or lost. If, however, there is no question of defective title, the cheque is good for all purposes, and may circulate in exactly the same way as a cheque which does not bear these restrictive words.

Account Payee Crossing—A cheque crossed 'account payee' or 'Pay A. B. C. only', restricts the transferability of the cheque. Although such crossing has no statutory significance, it must be paid to the payee specified and to him only. A banker should neither collect nor pay such a cheque if it bears evidence of having been transferred, otherwise the collecting banker will be liable for negligence, and the paying banker for disobeying the mandate of his customer.

CHAPTER XXVII

INDORSEMENT

THE word 'indorsement' is derived from the Latin *in dorsum* which means 'on the back'. Section 15 of the Negotiable Instruments Act defines indorsement as follows: 'When the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to indorse the same, and is called the "indorser" '.

EFFECT OF INDORSEMENT

By indorsing his name on the back of a negotiable instrument, the indorser guarantees to his immediate indorsee or a subsequent holder in due course that at the time it left his hands, it was genuine in every respect and that he had a good title to it. Ordinarily an indorser binds himself to pay only on due notice of dishonour being given to him. Section 35 of the Negotiable Instruments Act lays down, 'In the absence of a contract to the contrary, whoever indorses and delivers a negotiable instrument before maturity, without, in such indorsement, expressly excluding or making conditional his own liability, is bound thereby to every subsequent holder, in case of dishonour by the drawee, acceptor or maker to compensate such holder for any loss or damage caused to him by such dishonour, provided due notice of such dishonour has been given to, or received by, such indorser'.

CLASSIFICATION OF INDORSEMENT

There are four main types of indorsements as under :

(a) *Indorsement in blank.*—If the indorser signs his name only, and mentions no payee, the indorsement is said to be blank. A negotiable instrument so indorsed becomes payable to bearer. If, however, a negotiable instrument, which has been indorsed in blank, is subsequently indorsed in full, it cannot be paid except upon the indorsement of the indorsee in full.

(b) *Special Indorsement.*—A special indorsement or an indorsement in full specifies the person to whom or to whose order the negotiable instrument is to be payable. An indorsement in blank may be converted into a special indorsement by writing above the indorser's signature a direction to pay the negotiable instrument to or to the order of himself or some other person.

(c) *Restrictive Indorsement.*—An indorsement is restrictive which prohibits the further negotiation of a negotiable instrument or which expresses that it is a mere authority to deal with it as thereby directed and not a transfer of the ownership thereof, for example, an indorsement to the effect 'Pay D only', or 'Pay D for the account of X'. A restrictive indorsement gives the indorsee the right to receive payment of the negotiable instrument and to sue any party thereto that his indorser could have sued, but gives him no power to transfer his rights as indorsee unless it expressly authorizes him to do so. Where, however, a restrictive indorsement authorizes further transfer, all sub-

sequent indorsees take the negotiable instrument with the same rights and subject to the same liabilities as the first indorsee under the restrictive indorsement.

(d) *Conditional Indorsement.*—An indorsement which makes the transfer of a negotiable instrument dependent on the fulfilment of certain conditions is called a conditional indorsement. Section 52 of the Negotiable Instruments Act says, 'The indorser of a negotiable instrument may, by express words in the indorsement, exclude his own liability thereon, or make such liability or the right of the indorsee to receive the amount due thereon depend upon the happening of a specified event although such event may never happen'. The endorser can either completely exclude his liability or otherwise limit it by making it conditional. For example, he may exclude his liability by indorsing a cheque 'Pay A or order *sans recours* (or without recourse)'. This stipulation releases the indorser from liability in the event of the cheque being dishonoured, but does not release him from liability in respect of any forgery on the cheque before he indorsed it. Again, the indorser may make his indorsement conditional by making it depend on the happening of a specified event which may never happen. Thus an indorser may write, 'Pay A or order on his marriage with B'. In this case, the indorser will not be liable until the marriage takes place, and if B should die, his liability will be terminated.

It would appear that in India a banker cannot make payment of a cheque with a conditional indorsement until the condition is fulfilled. This is a difficult position for the paying banker inasmuch as a cheque is by definition an unconditional order payable on demand. Express provision has, however, been made in Britain under the Bills of Exchange Act affording protection to the banker for payment in disregard of conditions. Section 33 of this Act says, 'where a bill purports to be indorsed conditionally, the condition may be disregarded by the payee and payment to the indorsee is valid, whether the condition has been fulfilled or not'.

General Principles Regarding Indorsement

Although the appropriateness or otherwise of an indorsement is determined by the general practice of bankers, certain general principles guiding indorsement may be stated :

1. An indorsement should be spelled exactly in the same way as the person's name appears on the face of the bill (or cheque) as payee, or in the special indorsement as indorsee. If the name is mis-spelt, the indorsement should also be mis-spelt, and the indorser may again indorse it with his name spelt correctly.
2. An indorsement should be in the form of the ordinary signature of the payee or indorsee. Complimentary prefixes or suffixes or other courtesy titles such as Mr, Mrs, Miss, Dr, M.A., B.L., Sir, etc., do not form part of the indorsement, and should be omitted while indorsing a bill.

   Women.—A spinster or unmarried woman indorses by writing her first name and sur-

name. Thus Miss Kamala Bose will indorse as Kamala Bose. If the payee is a married woman or a widow, and a cheque is made out in favour of Mrs A. Bose, she should sign as K. Bose, wife or widow of A. Bose. If a cheque is made payable to a married woman in her maiden name, as a cheque drawn in favour of Miss Kamala Das, she should indorse it as Kamala Bose *née* Das.

3 *Illiterate persons.*—In the case of illiterate persons the left hand thumb impression should be impressed and witnessed, the witness giving his or her address.

4. Cheques made payable to two or more persons, not partners, must be indorsed by each of them individually.

5. When a cheque is made payable to a club, association or other institution, the name of the payee should be followed by the name and designation of the officer indorsing the cheque.

6. In the case of corporations, the mere writing or impressing of the name of the company by a person acting on its authority may constitute a valid indorsement. But bankers do not usually accept such indorsement. Usually, bankers accept indorsements made by directors, managers or secretaries of companies.

7. *Per pro indorsement.*—A banker is not legally obliged to accept such indorsement and can demand confirmation.

8. Cheques made payable to deceased persons must be indorsed by the legal representatives. As executors can delegate authority, there is no objection if only one of them signs.

SOME SPECIMEN INDORSEMENTS

Payee	Irregular indorsement	Regular indorsement
INDIVIDUALS .		
Mahatma Gandhi	Mahatma Gandhi,	M. K. Gandhi
Professor Niyogi ...	Professor Niyogi ..	J. P. Niyogi
WOMEN ·		
Miss Bose ...	Miss Bose ...	Kamala Bose
Mrs. A. Bose ...	Mrs. A. Bose ...	Kamala Bose (wife or widow of A. Bose)
Miss Kamala Das (now married)		Kamala Bose (*née* Das)
CLUBS & ASSOCIATIONS . University Commerce Society	A. Roy, Secretary, University Commerce Society	For the University Commerce Society A. Roy Secretary
FIRMS		
Das & Sons ...	A. K. Das & Sons	Das & Sons or For Das & Sons A. K. Das Partner
JOINT-STOCK COMPANIES · India Co., Ltd. ...	For India Co., Ltd. B. C. Das or B. C. Das and Company, Managers	For India Co., Ltd. B. C. Das Manager, Secretary or Director *or* For India Co., Ltd. B. C. Das & Co., Managing Agents.

SOME SPECIMEN INDORSEMENTS—(*Contd.*)

Payee	Irregular indorsement	Regular indorsement
EXECUTORS & ADMINISTRATORS : B. C. Ray (now deceased) ...	A. N. Ray ...	For self & co-executor of the estate of the late B. C. Ray A. N Ray
TRUSTEES : P. K. Bose & H. Sarcar Trustees of the estate of the late H. R. Dey.	P. K. Bose ... H. Sarcar ...	P. K. Bose & H. Sarcar Trustees of the estate of the late H. R. Dey

CHAPTER XXVIII

THE PAYING AND THE COLLECTING BANKER

THE PAYING BANKER

IT is the duty of the paying banker to honour his customer's cheques subject to certain conditions. These conditions are, first, that the customer must have a current or drawing account upon which the banker usually allows cheques to be drawn ; secondly, that the state of the customer's account must warrant the payment, that is, he must have sufficient funds to his credit or there must be an arrangement for overdraft adequate to cover the cheques ; thirdly, that the cheque must be presented by the holder or his authorized agent during recognized business hours at the proper place of payment ; fourthly, that it must be drawn in the proper form , and finally that there must be no legal reason or excuse for refusing payment.

A cheque is drawn in the proper form when it (*a*) is signed by the drawer himself or by his authority ; (*b*) is due for payment, that is, is not post-dated or stale ; (*c*) has the sum, to be paid expressed in words, or in words and figures, which should agree ; (*d*) purports, if it is an order cheque, to be properly indorsed ; and (*e*) bears the drawer's confirmation for any material alteration.

The following are sufficient reasons for refusing payment :

(*a*) Notice from the customer to stop payment.
(*b*) Knowledge of any defect in the title of a person presenting the cheque for payment.
(*c*) Notice of an act of bankruptcy by the customer,

or an intimation of his death or insanity, or, in the case of a company, notice of its winding up.

(*d*) Notice of an assignment by the customer of his available credit balance.

(*e*) Knowledge that the customer contemplates breach of trust where it is known that funds credited to the account are trust funds.

(*f*) Notice of garnishee injunction or other order from a court restraining the customer from operating the account.

Return of Unpaid Cheques.—When a cheque is returned unpaid by a banker, it should be returned with a slip stating the reason for the refusal of payment. A banker must neither offer part payment of a cheque nor disclose the state of his customer's account. The most common answers given on the slip for returning a cheque unpaid are: (*a*) *Refer to drawer* or *not sufficient funds*, meaning that the banker has not sufficient funds at his disposal to honour the cheque; (*b*) *Endorsement irregular*, that is, the indorsement on the cheque is not in order; (*c*) *Effects not cleared*, that is, the drawer has paid in bills or cheques which are in course of collection, but the proceeds are not yet available for paying the cheque.

Chief Risks of a Paying Banker.—The chief risks of a paying banker are (*a*) forgery of the drawer's signature and (*b*) fraudulent alterations, such as alterations of amount.

As the banker has a specimen signature of his customer, he should not honour any cheque when he has a reasonable suspicion or doubt that the signature on it differs from the specimen signature in his possession. Even if the signature be so cleverly forged that the banker is unable to detect the forgery, he will not be able to debit the

customer's account with the amount, as he has evidently had no instructions from his customer to do so (*Bhagwandas vs. Creet*). If, however, the customer should, by his conduct, cause the banker to believe that the signature is genuine, the banker will be able to debit the customer's account even though subsequently it should transpire that the signature had been forged. Such a case may arise if the customer was present at the bank, showed his signature, and signified it good for payment even though the signature may not have been genuine.

Corresponding to the obligation of the banker to inform his customer on receipt of a cheque with a forged signature is the duty of the customer to inform the banker if he should come to know that forged cheques are being presented. If the customer fails to do so and if thereby the chances of recovery from the forger are materially prejudiced, the customer will be precluded from claiming the amount back from the bank (*M'Kenzie vs. British Linen Co.*). In *Greenwood vs. Martins Bank Ltd.*, the husband did not disclose, although he was aware of it, that his wife was committing forgery until after she had committed suicide. In this case, the husband was held to be estopped by his conduct from making any claim against the bank on the ground of his silence and inaction when there was a duty to speak.

In respect of any material alteration, it has been already stated that any such alteration unauthorized by the drawer renders the cheque void, and a banker paying such a cheque will be liable to the customer for the consequences.

Protection of a Paying Banker.—The paying banker has been afforded certain statutory protection in respect of difficulties faced by him by reason of forged or unauthorized indorsements. Section 85 of the Negotiable Instruments

Act reads: (1) Where a cheque payable to order purports to be indorsed by or on behalf of the payee, the drawee is discharged by payment in due course. (2) Where a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof, notwithstanding any indorsements whether in full or in blank appearing thereon, and notwithstanding that any such indorsement purports to restrict or exclude further negotiation.

'Payment in due course' has been defined in Section 10 as meaning 'payment in accordance with the apparent tenor of the instrument in good faith and without negligence to any person in possession thereof under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount therein mentioned.

The holder to whom payment is to be made may be the payee, indorsee or bearer according to the nature of the instrument or the way in which it has been made out. It is not in the ordinary course of business to pay cheques outside business hours except through the clearing house. If a banker does so, he loses statutory protection and may also face the possibility that the drawer may countermand the payment of the cheque before the bank opens on the next business day.

The duties of and the protection available to the paying banker in respect of crossed cheques are laid down in Sections 126, 127 and 129. The Sections run as follows:

Section 126.—Where a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise than to a banker. Where a cheque is crossed specially, the banker on whom it is drawn shall not pay it

otherwise than to the banker to whom it is crossed, or his agent for collection.

Section 127.—Where a cheque is crossed specially to more than one banker, except when crossed to an agent for the purpose of collection, the banker on whom it is drawn shall refuse payment thereof.

Section 129.—Any banker paying a cheque crossed generally otherwise than to a banker, or a cheque crossed specially otherwise than to the banker to whom the same is crossed, or his agent for collection, being a banker, shall be liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid.

A banker is thus not justified in paying a cheque inconsistent with the directions in crossing. It follows that if the crossing is such that the banker is left in doubt, he should return the cheque. Further, a crossed cheque drawn by one cutsomer in favour of another should be passed through the payee's account. The banker is not legally justified in paying money over the counter to even a payee-customer. If the banker should give cash for a crossed cheque to the payee, even though well-known to him, he does so at his own risk.

If payment of a crossed cheque has been made in due course, the paying banker is discharged from all liabilities under Section 128. This Section says, 'where the banker on whom a crossed cheque is drawn has paid the same in due course, the banker paying the cheque, and (in case such cheque has come to the hands of the payee) the drawer thereof shall respectively be entitled to the same rights, and

be placed in the same position in all respects, as they would respectively be entitled to, and placed in, if the amount of the cheque had been paid to and received by the true owner thereof'. On payment in due course, the banker is entitled to debit the drawer with the amount of the cheque, and will not be liable if the amount does not reach the true owner.

The Collecting Banker

As an agent of his customer, the collecting banker has certain responsibilities towards his customer. He incurs certain liabilities if he fails to discharge the duties entrusted to him. His duties are not always precisely defined, and whether or not he has fully discharged them will depend as much upon the circumstances of the particular case in question as the recognized banking practice of the particular place. A banker will, however, in any case be liable to his customer for any loss or damage which may result from his negligence or omission to use reasonable care and diligence.

The Banker Collecting on His Own Behalf.—Sometimes a banker may collect cheques and bills, not as an agent, but for himself as a holder for value, for example, when he encashes an open cheque over the counter, or collects proceeds of cheques specifically paid in to reduce a loan due to him or collects cheques against which he has given the customer the right to draw before the proceeds have been realized. In such circumstances, a banker becomes a holder in due course, collecting the proceeds for himself although they may ultimately rest in the customer's account, and has all the rights of such a holder. If he collects an open or uncrossed order cheque for himself, he is liable to the true owner only if the indorsement is forged. But he can enforce his rights as a transferee against any

indorsers who indorsed after the forgery as also against his immediate transferor if that person has omitted to indorse the cheque. If, however, the question is one of absence of or defect in the title of the person from whom the banker took the instrument, the banker as a holder in due course will have power to enforce payment against all prior parties to the instrument.

Collection of Cheques for a Customer.—The banker is afforded no protection in collecting uncrossed bearer or order cheques for a customer. If such a cheque bears a forged indorsement, or if the customer's title to it is lacking or defective, the banker will be liable to the true owner for conversion. The banker may, however, be able to debit the amount of the cheque to the customer concerned.

A collecting banker obtains certain statutory immunity in connexion with the collection of crossed cheques, whether payable to bearer or order. Section 131 of the Negotiable Instruments Act provides as follows: 'A banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself, shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment'. In 1922, the following explanation was added: 'A banker receives payment of a crossed cheque for a customer within the meaning of this section notwithstanding that he credits his customer's account with the amount of the cheque before receiving payment thereof'.

The statutory protection is available only on the following conditions being fulfilled, namely:

(*a*) The cheque must be crossed, and crossed before it reaches the hands of the banker.

(*b*) The banker must collect the cheque on behalf of a customer.

(*c*) The banker must collect the cheque as an agent, and not as a principal. It is the usual practice of bankers to credit cheques to the customer's account even before the receipt of the proceeds. In the *Gordon* case, it was held that the crediting of cash before the receipt of the proceeds of a cheque made the collecting banker a transferee for value, and as such, he was not entitled to the statutory protection even if the cheque was crossed. To negative the effect of this decision, the Bills of Exchange (Crossed Cheques) Act was passed in 1906 in Britain, and the provision of this Act has been embodied in the explanation added in 1922 to Section 131 of the Negotiable Instruments Act.

(*d*) The banker must receive payment in good faith and without negligence. As bankers do not act otherwise than in good faith in all their dealings, the question of good faith in connexion with the collection of cheques is not of much practical significance. The more important question is what would constitute negligence. The Privy Council stated in *Commissioners of Taxation vs. English, Scottish Australian Bank Ltd.* that the test of negligence within the meaning of this section is whether the transaction of paying in any given cheque was so out of the ordinary course that it ought to have aroused doubts in the banker's mind and caused him to make enquiry. As

illustration of what would amount to negligence in respect either of the paying or the collecting banker may be cited the following circumstances :

(i) Omission to verify the correctness of indorsements on cheques payable to order ;
(ii) Omission to verify the existence of authority in the case of per procuration signatures if there are any circumstances connected with the transaction which should put the bank on enquiry ;
(iii) Collecting for a partner's private account cheques payable to the partnership firm ;
(iv) Collecting for the private account of an official cheques made payable to his company or firm and indorsed by him on its behalf ;
(v) Omission to obtain a reference from a new customer ;
(vi) Collecting a cheque crossed 'account payee' for other than the payee named ;
(vii) Where the operations on an account are of an unusual nature.

Account Payee Crossed Cheque.—Words such as 'account payee' or 'payee's account' or 'account A.B.C.' are often added to a crossing. They have no statutory significance. Yet they are in the nature of a direction to the collecting banker who would be guilty of negligence if he were to override such direction, and would, as a result, lose protec-

tion of Section 131 of the Negotiable Instruments Act. Such a direction has, however, no significance for the paying banker, whose responsibility ceases with the paying of the cheque in good faith and without negligence. An 'account payee' crossed cheque must be collected for the credit of only the account of the payee named.

Conversion and Money Had and Received.—Conversion may be defined as the wrongful intermeddling with the goods of another for the purpose of taking them away from the party entitled to them, and may be constituted by taking, using or destroying the goods or exercising over them some control which is inconsistent with the owner's right. The term 'goods' includes a bill of exchange, promissory note or cheque A person who is innocently in possession of the goods, and has throughout acted without negligence, is yet liable for conversion. The liability exists even in the case of a person who is merely acting as an agent for another, for conversion is a tort which renders the person committing it personally liable, as also the principal on whose behalf the agent was acting while committing the wrong. Thus a banker who has collected a negotiable instrument bearing a forged indorsement in behalf of his customer will be liable to the true owner for conversion, however innocently he may have acted, unless he can claim statutory protection, for example, in the case of crossed cheques.

In an action for conversion of a negotiable instrument, the true owner often adds an alternative count 'for money had and received' to his use. The claim for money had and received against a person who had no knowledge of the rights of the true owner is based on an implied promise, which the law imputes to the person dealing with the

money of another, to repay that money to the true owner when demanded.

The following are the common instances in which a banker may render himself liable, in the absence of statutory protection, for conversion:

(*a*) Paying a cheque bearing a forged indorsement. The paying banker is, however, protected under Section 85 of the Negotiable Instruments Act in the case of uncrossed cheques and under Sections 126 to 129 of the Act in case of crossed cheques if the payment has been made in due course.

(*b*) Collecting a cheque, bill of exchange, or promissory note bearing a forged indorsement, or in respect of which the customer has no title or a defective title. This liability is absolute in so far as bills of exchange and promissory notes are concerned, but statutory protection has been given to the banker under Section 131 of the Negotiable Instruments Act in connexion with the collection of crossed cheques.

(*c*) Taking for value a bill of exchange, cheque or promissory note bearing a forged indorsement, or a cheque crossed not negotiable, to which title is void or defective. There is no statutory protection in this case.

(*d*) Delivering to a wrong person goods which have been entrusted to him for safe custody.

XXIX

ADVANCES AGAINST SECURITIES

By far the most important item of the assets of a commercial bank consists of loans and advances granted against securities. These securities may be classified under two broad heads, personal and collateral. This division corresponds to the distinction made by the Indian Companies Act between unsecured and secured loans. Under this Act, advances made by a registered company including a bank have to be shown separately in the balance-sheet as secured and unsecured. This nomenclature has, however, had an undesirable effect, for advances which are made against the personal security of the borrower have to be shown as unsecured, which term conveys a feeling of unsoundness in the popular mind, and, as such, these advances are discouraged by bankers, although in effect they may be in no way inferior to what are known as secured advances. In Great Britain, for example, advances against the personal security of the borrower supported by a guarantee are common. They constitute, however, but a very small proportion of the advances made by Indian banks.

An unsecured advance is one for which the banker has to depend only upon the personal security of the borrower. The basis of such advance is the credit of the borrower-customer. In the event of the default of the borrower, the banker has only a personal right of action against the borrower.

A 'collateral security' has no strictly defined application. In general, a secured advance or one given against some

collateral security means an advance in which the bank has, in addition to his personal right of action against the borrower, the security of some form of a collateral. The term 'collateral' or 'collateral security' applies to share certificates, bearer bonds, title deeds, life policies, etc.

A guarantee, under which a third party, the guarantor or surety, makes himself responsible to the banker for the repayment of the debt of the borrower, may, in a broad sense, be regarded as a collateral inasmuch as it is in addition to the personal security already offered by the borrower, but it is recognized more appropriately to fall into the category of personal securities for the reason that it is not a tangible security.

Advances against Personal Security

The term 'personal security' is applied to those classes of security which involve a right of action against only the individual or individuals giving the security. It is to be distinguished from securities which can be realized by sale or transfer. Apart from bills of exchange, the principal forms of personal security are promissory notes and guarantees.

Advances against Borrower's Promissory Notes

The banker lends money against the personal undertaking of the borrower, and if the loan is unpaid, his remedy is to sue the borrower. Before, however, a banker agrees to lend against the borrower's I.O.U., he satisfies himself that the borrower will be able to return the money in a short period and that the loan will be used for genuine trade purposes. The basis of such credit is commonly referred to as the three C's or the character, capacity and capital of the borrower, and also as the three R's, the borrower's

reliability, responsibility and resources. In evaluating these attributes of a prospective borrower, the banker asks for the latest balance-sheets and profit and loss accounts of the borrower's business certified by an auditor over a period of years so as to find out his financial position and he also collects information from other sources about the borrower's financial standing and credit-worthiness. Unfortunately, there are no credit agencies in India like Seyds in Britain or Duns and Bradstreets in the U.S.A., which could have been of great benefit to financial institutions and other lenders in obtaining valuable information about their prospective borrowers. Indian bankers may obtain information about borrowers from other banks with which these borrowers may have had dealings, and from reports in the market. The main basis for assessing a borrower who has nothing but personal security to offer is the balance-sheet and profit and loss account of his business.

ADVANCES AGAINST GUARANTEE

A guarantee is a contract under which one person, called the guarantor, undertakes to be answerable for the payment of a debt or the performance of some act by another person, who must be legally bound to pay the debt or to perform the act concerned. A contract of guarantee presupposes a prior contract in existence, upon which the principal debtor is liable to the creditor. The guarantor becomes liable only in the event of the default of the principal debtor. Thus, a contract of guarantee is a secondary one.

Guarantee and Indemnity.—A contract of guarantee should be distinguished from a contract of indemnity. An indemnity may be valid though not in writing, but a guarantee must be in writing. The person who gives an

indemnity makes himself primarily responsible for the debt, but the person who gives a guarantee is liable on the failure of the debtor to pay the debt. In a contract of guarantee, there must be two contracts, a principal contract between the borrower and the lender and a secondary one between the lender and the guarantor or surety. In a contract of indemnity there is only one primary contract.

Specific and Continuing Guarantees.—A specific or non-continuing guarantee is one in which the guarantor undertakes to be answerable only in respect of a specific transaction or in respect of a fixed amount, for example, in the case of a particular advance granted to a debtor on a separate loan account Such a guarantee cannot be revoked by the surety so long as the loan is not repaid, but once the loan is paid back, the agreement becomes void and cannot be enforced in respect of any future advances. A guarantee may also be given for a specified period. Such a guarantee may be determined at any time within the period on the guarantor's giving notice and repaying any money then due. The guarantee would in any case expire on the specified date, and the banker must take necessary steps to enforce his rights against the guarantor before the expiry of that date.

A continuing guarantee is one under which the guarantor is held liable for the fluctuating balance owing, on the debtor's account, at any time, during the continuance of the guarantee, subject to any limit which may be specified. A continuing guarantee is not affected by any repayments made, that is, by the *Rule in Clayton's* case, as the guarantor is liable for any ultimate balance due on the debtor's account. A continuing guarantee is usually subject to a month's notice for its termination. Where no provision for notice is made in the guarantee, it may be deter-

mined at any time. Upon receipt of notice, the banker must at once communicate it to the customer and stop the account so as to prevent the operation of the *Rule in Clayton's* case.

The Form of a Banker's Guarantee.—A banker's guarantee is in writing, and must at least contain the names of the parties, the signature of the surety and the essential terms of the contract. A banker's guarantee usually states the consideration, but it is not invalid merely by reason that the consideration is not stated therein. The consideration may be the granting of an advance to a customer against the guarantee, or of further time to a debtor. A banker's guarantee should usually be a continuing guarantee. It may further provide that the contract shall not be prejudiced if any other securities are taken from the debtor, nor by any arrangements made with the debtor regarding the exchange or release of securities, or for the giving of time in which to pay. If, however, these provisions are not contained in the contract of guarantee, the happening of any of these events will alter the conditions under which the guarantee was given and the guarantor will be discharged from his liability.

A guarantee may be given by one person only, or by two or more persons. In the latter case, the guarantee is always stated to be a joint and several guarantee on the part of the guarantors.

The Banker and the Guarantor.—A banker should always explain to a new guarantor the nature of the contract into which he is entering and his liabilities, and also see that the surety signs of his free will and without any pressure from the debtor or the banker. Any enquiries made by a surety should be fairly and fully answered by the banker. A contract of guarantee is not one which comes within

the category of contracts described as *uberrimae fidei*, that is, those which require a full disclosure of material facts by all parties. So long as there is no concealment amounting to fraud, a banker need not disclose the actual state of the debtor's account or provide information concerning the debtor's affairs or business habits unconnected with the contract of guarantee. If, however, the guarantor should be labouring under a misapprehension in any matter, the banker should try to remove it.

When the Guarantee is Determined.—A guarantee is determined either (1) at the will of one or some of the parties, for example, (*a*) the repayment by the principal debtor, (*b*) the repayment by the guarantor; and (*c*) a demand for repayment by the banker; or (2) by operation of the law, for example, on the death, insanity or bankruptcy of the surety or of the principal debtor, or on a change in the constitution of a firm if the guarantee is given by or in favour of a partnership, or on the amalgamation of a company if the guarantee is given by, in favour of, or to a joint-stock company.

ADVANCES AGAINST COLLATERAL SECURITIES

In its strict sense, the term 'collateral security' implies the offer of a security in addition to some other security for a debt. In practice the personal credit of the borrower is regarded as the primary security and any other tangible security offered is regarded as collateral.

Before a banker accepts any security as a collateral, he has to consider a number of points, the important among which are: (*a*) easy shiftability. The security should be readily saleable in the market; (*b*) stable value. A security which is subject to wide fluctuation in value is not a desirable collateral; (*c*) sufficient margin for loss. The banker

does not usually advance money up to the full value of the security. He usually maintains a margin to safeguard against any possible depreciation in the value of the security accepted as a collateral ; (*d*) simple and safe title. A customer's title to the security should not only be simple but also secure against loss by theft or fraud. This is necessary so that the banker's title to the security may be perfected, whenever necessary, without any difficulty ; (*e*) transfer of the title should be cheap and easy, so that the banker may obtain complete transfer of the title to himself or to his nominee without much trouble or expense ; (*f*) the absence of liability. A banker may hesitate to take a security which will involve him in liability to third parties, for example, shares on which calls may yet be made.

How Security is Taken

There are four main ways in which a banker may acquire an interest in the property of a debtor as collateral security, by lien, pledge, hypothecation and mortgage.

Lien.—A banker's lien has already been explained on page 286. Lien is an informal security, and differs from the other forms of charge in that it is not the subject of a formal or express contract. It is essentially an implied charge and arises by operation of the law out of the ordinary course of dealings between the banker and his customer.

Pledge.—When negotiable instruments and goods, or the symbol of goods, such as bills of lading or dock warrants, are delivered to a banker as security for a debt, the delivery is termed a pledge or a pawn. The delivery may be actual or constructive, as when the keys of a godown or the documents of title to goods are delivered. To constitute a pledge, there must be an express or implied contract between the borrower and the lender, but the property in the

security remains vested in the pledgor. The pledgee—in our case, the banker—has a right to retain the goods or securities until repayment of the debt, and in case of default, to realize them after reasonable notice to the debtor.

Generally speaking, a pledge is evidenced by a Memorandum of Deposit or a Memorandum of Charge, which provides particulars of the securities, of the purpose of the deposit and of the amount and limit of the advance. It also provides usually that the security shall be a continuing one.

Hypothecation.—Hypothecation resembles a pledge in many ways, but does not involve the actual passing of the control of the property into the possession of the creditor ; for example, a debt due by a third party may be hypothecated. It is also used to describe an arrangement by which the pledgor may hold the property hypothecated under a letter of trust or trust receipt, that is, the pledgor agrees to hold the goods hypothecated in trust for sale for the pledgee,—in our case, the banker—and to pay the proceeds into his account.

Mortgage.—A mortgage is a conveyance of an interest in property for the purpose of securing a debt, but the term is usually reserved for a conveyance of an interest in land or immovable property. A mortgage may be either legal or equitable. A legal mortgage is created by deed and gives the mortgagee the right of sale in case of default on the part of the mortgagor. An equitable mortgage is effected by the simple deposit of the deeds of property, but the mortgagee can obtain a power of sale only by application to court. The Memorandum of Charge taken to obtain an equitable mortgage of property, of which the deeds are deposited by a customer with the bank as security for advances, usually stipulates that the mortgagor will

execute a full legal mortgage in favour of the bank if asked to do so. The mortgaged property in either case usually remains in the possession of the mortgagor, who has the power to reclaim the full ownership of the property by properly discharging the mortgage.

Stock Exchange Securities.—The principal forms of collateral securities are Stock Exchange securities, goods and documents of title to goods, real estate, and life insurance policies Of these, Stock Exchange securities are by far the most important. They satisfy the conditions which a banker considers necessary that a security taken as a collateral should possess. The banker will, of course, accept such securities as are quoted on the Stock Exchange, which have a ready market and which are not speculative in character like mining, oil and rubber shares.

Stock Exchange securities include stock and share certificates, debentures, bearer bonds and scrip certificates issued by companies and corporations, local authorities or home or foreign governments. They are generally divisible into two broad categories, (*a*) fully negotiable or convertible securities, and (b) non-negotiable or inconvertible securities.

Fully Negotiable Securities.—Fully negotiable Stock Exchange securities are bearer bonds, scrip and share warrants to bearer, East India bonds and bearer debentures. If these securities are taken in good faith and for value, the holder is entitled to retain them against the true owner, even though the true owner may be a beneficiary under a trust and the trustee has fraudulently transferred them to the holder. This is the essence of a fully negotiable security.

Fully negotiable securities constitute an ideal cover for an advance. They are stable in value and readily market-

able. Further, if the customer fails to repay the debt, the banker may obtain full legal title to the securities by virtue of his general lien, even though they may not be deposited with a Memorandum, and whether securities actually belong to the customer or not, provided the banker has no notice of any defect in the title of the customer.

Mere deposit of a fully negotiable security gives the banker a complete title, but it is the usual practice to take a Memorandum of Deposit showing the purpose of the deposit, stating that the security shall be a continuing one, and containing a clause empowering the banker to realize the security, in case this should be necessary. The only possible danger of taking a fully negotiable security is that it may be lost or stolen while in the possession of the banker.

Non-Negotiable Securities.—These securities may further be sub-divided into two groups: (*a*) inscribed stock; (*b*) registered stocks and shares.

Inscribed stocks are so called because the holders of these stocks and the amount of their holdings are 'inscribed', that is, recorded, in the books of the particular bank or other agent through which all dealings in the stocks are transacted. No certificates are issued to the holders of inscribed stock. The transfer of an inscribed stock can be effected only if the owner personally attends or appoints an agent under power of attorney to attend on his behalf the stock transfer office of the registering bank or agent. Certain British Government stocks are inscribed in the books of the Bank of England. Attendance by the owner or by his duly empowered agent at the Bank is essential before the title can be transferred. The receipt or acknowledgement issued to the owner of this kind of stock is valueless as a security. It is necessary for the bank to have the stock transferred to itself or to its nominee by an actual transfer in the books

of the issuing bank or agent in accordance with the procedure detailed above.

Registered stocks and shares are those which are evidenced by certificates given under the seal of the issuing body, and a full legal title to property may be transferred by the delivery of the certificate accompanied by a transfer in writing or under seal.

Certificates of registered shares, being non-negotiable instruments, are more appropriately secured by mortgage than by pledge. Mortgage may either be equitable or legal.

Legal title is obtained by the execution of the transfer of the security to the bank or its nominee, the transfer being accomplished in accordance with the rules of the issuing company. These rules are generally laid down in the Articles of Association of the company and usually provide that the transfer shall be in writing (or sometimes under seal), executed by transferee and transferor, and that the transferee shall not become a holder of the security until his name has been entered in the company's register of shareholders. Although a certificate of membership is always issued to the transferee, its existence is not essential to constitute a person a shareholder. A legal transfer of title to the banker is, however, not without risk. For one thing, the banker renders himself liable as transferee for an indefinite period to indemnify the company against any loss it may incur if it should transpire that the transferee's signature to the instrument of transfer had been forged. For another, he retains a liability in respect of partly paid-up shares for any future calls that may be made.

Equitable title to stocks and shares may be obtained by any of the following methods: (*a*) mere deposit of the certificates This procedure is rarely adopted ; (*b*) deposit of certificates with a Memorandum of Deposit ; or (*c*) depo-

sit of certificates with a Memorandum of Transfer and a duly executed blank transfer.

The Memorandum is taken to safeguard the position of the banker. It usually provides that the banker shall have an immediate power of sale of the security if the customers should make default in payment, that the security shall be a continuing one, and that the banker will be able to debit the customer for any expenses incurred, for example, for payments made on partly paid-up shares in respect of calls made upon them. A blank transfer is the usual form of transfer required by the issuing body, which is filled in except for the insertion of the name of the transferee, and is signed by the customer and witnessed, but is not stamped or dated.

Although from the point of security, the transfer of legal title is the safer procedure, yet in many cases, particularly where the advance is required for a short period, the banker will accept an equitable mortgage and not subject his customer to the trouble, expense and publicity involved in legal transfer Advances to stock-brokers are always granted against equitable mortgage effected by deposit of securities together with a Memorandum and blank transfer forms.

The banker should take certain precautionary steps in case of equitable mortgage. He should, in the first place, send a notice to the company of his lien on the stocks or shares concerned. Secondly, he should not part with the security until the debt has been repaid. Lastly, he must observe the utmost good faith throughout the transaction.

ADVANCES AGAINST GOODS AND DOCUMENTS OF TITLE TO GOODS

Expert opinion on the desirability of granting advances by a banker against goods or documents of title to goods is

conflicting. Sir John Paget opined that these are convenient securities for advances under proper safeguards. On the contrary, Mr Gilbert and Mr Hutchison expressed the opinion that no prudent banker should ordinarily make advances upon such securities. The modern view, which is borne out by actual experience, is that such securities are sound if adequate precautions are taken to safeguard the position of the lender.

The grant of advances against the security of goods calls for some amount of specialized knowledge on the part of the banker. Apart from the necessity of ensuring the validity of the documents and dealing with persons of known integrity, the banker has to consider carefully the quality, value and freedom from deterioration of the goods concerned. A banker should not usually accept as security goods which are easily perishable or liable to violent fluctuation in prices or likely to be affected by vagaries of demand or fashion. He must also protect himself against risk of fraud in respect particularly of the uniformity of the quality of the goods offered as security.

Advances against goods or produce.—When advances are made directly against the security of goods or produce, the goods are generally stored either in the bank's or in the borrower's godown. This is due to the lack of public warehouses in India. If warehouses in sufficient number existed, goods could be stored in them and could be offered as security by delivering to the banker the warehouse-keeper's warrant duly indorsed by the borrower. This would in effect constitute an advance against the security of document of title to goods. In India, if goods are stored in the bank's godown, a rent has to be paid to the banker, and insurance is also effected at the borrower's cost.

Advances against Documents of Title to Goods.—In

making advances against such documents, the banker should satisfy himself that they are complete and in order, and that they are properly stamped, whenever necessary. He should also take care to distinguish between documents which in themselves give title to specified goods, such as bills of lading and dock or warehouse-keeper's warrants, and documents which are mere receipts of acknowledgement of deposit of goods in named warehouses, such as warehouse-keepers' receipts.

The principal documents of title to goods are: (*a*) Bills of Lading ; (*b*) Dock and Warehouse Warrants (*c*) Delivery Orders.

Bills of Lading.—A bill of lading is a document signed by the master of a ship, acknowledging the receipt on board the ship of certain specified goods for carriage, and embodying an undertaking on behalf of the ship-owners to deliver the goods to the consignee or his order or assigns upon payment of the freight or any other charges stipulated for. A bill of lading is drawn in sets usually of three or four parts.

A bill of lading is not a negotiable instrument. If it is drawn to a named person only, it is known as a *straight bill of lading* and the goods specified must be delivered to the person named and to him only. If, however, it is drawn to order, the title to the goods may be transferred simply by delivery of the bill after proper indorsement by the shipper. But the transferee, even if he takes the instrument or value and in good faith, cannot acquire or pass a better title to the bill than that of his immediate transferor.

The following precautions should be observed in connexion with the making of advances against the security of bills of lading: (*a*) they should be drawn to order or assigns, so that they may be transferred by indorsement and

delivery ; (*b*) they should be examined to ascertain whether they contain clauses necessitating payment of heavy charges or which may otherwise operate to the detriment of the lender (*c*) while they are conclusive evidence of shipment of goods, they afford no evidence of either the quality or the value of the goods. The lender may therefore insist upon the production of an invoice ; (*d*) they should be examined to find out whether they acknowledge that goods have been shipped in good order and condition, that is, whether they are clean bills or not. If shippers qualify their acknowledgement by stating that the goods in certain respects are defective, the bill is said to be 'claused', foul or dirty ; (*e*) the goods evidenced in the bills of lading should be covered by a marine insurance policy ; (*f*) all the different sets of bills of lading should be deposited with the banker.

Dock and Warehouse Warrants.—Dock and warehouse warrants are documents in a variety of forms issued by dock companies, warehouse-keepers, or wharfingers stating that goods as described therein are registered in their books, and are deliverable to persons named in the warrants or their assigns by indorsement. The transferee of such a warrant obtains a title which will be affected by any defect in the title of the transferor inasmuch as these warrants are not negotiable instruments. Although a warrant passes the title in the goods concerned, it does not operate as a transfer of possession. A banker who takes such a document, should give notice of his claim to the holder of goods, so that a new warrant in his name may be issued. He will also have the goods insured against fire and theft at the borrower's cost.

A warehouse-keeper's certificate or receipt is issued by a warehouse-keeper stating that he holds certain goods

described therein and awaits instructions from the person to whom the receipt or certificate is addressed in regard to their disposal. The certificate or receipt is not a document of title, but a mere acknowledgement, for the owner may obtain possession of the goods without its surrender by signing and forwarding to the warehouse-keeper a delivery order. If a banker should advance any money against a warehouse-keeper's certificate or receipt, he should also obtain a delivery order from the borrower, so that he can obtain possession of the goods and have them stored in his own name.

Delivery Order.—This is a document addressed by the owner of goods to the owner of a dock or warehouse in which the goods are stored instructing him to deliver either all or some of the goods to a named person or to his assigns Unless the holder of a delivery order at once obtains delivery of the goods, or obtains in its place a warrant or receipt from the warehouse-keeper, or gets his title registered in the warehouse-keeper's books, he runs the risk of a second delivery order being acted upon. When advancing money against delivery orders, a banker should take a letter of lien or hypothecation signed by the customer and instruct the warehouse-keeper to store the goods in the bank's name. In the event of the owner's bankruptcy before the goods are registered in the bank's name, the property will vest in the trustee in bankruptcy.

In India, delivery orders in respect of hessian or gunny bags are a very popular form of security for making advances by banks.

Letter of Hypothecation.—A banker usually obtains a document of charge called a letter of hypothecation from his customer when granting him an advance against the security of a document of title to goods. The letter of

hypothecation pledges the documents with the banker as security, authorizes him to deal with the goods in any way he considers necessary, to insure and store them at the customer's expense in his own name, to sell them if necessary and to apply the proceeds of sale towards repayment of any advance or payment made by him to the pledgor. If the sale proceeds should be insufficient to meet his dues, the banker will still have recourse to the customer under the letter of hypothecation for any balance due.

Trust Receipts.—When the banker parts with the goods or documents of title to goods before receiving the amount due from the customer, he obtains a trust receipt signed by the customer. The trust receipt embodies an agreement by the customer hypothecating the goods to the banker as security for the advance, and undertaking to hold them and any proceeds received in respect thereof as a trustee for the banker, so long as the entire amount due to the banker is not paid off. Should the customer fail to pay the sale proceeds to the banker, he would be liable for criminal breach of trust.

ADVANCES AGAINST LAND AND BUILDINGS

Advances against land and buildings are not popular with commercial banks, as they are not readily realizable securities. Further, various legal formalities that have to be observed are another handicap. If, again, there are any legal restrictions to the transfer of property, many complications arise for the banker. For all these reasons, and particularly because the security is not liquid, a commercial bank's advances against such securities are very small.

A banker avails himself of such securities by way of mortgage. In India, even equitable mortgage of property by the deposit of title deeds is recognized by law. An

equitable mortgage is simple and less costly. Further, it avoids publicity which the borrower may dislike. But it has the disadvantage that the title of an equitable mortgagee may be defeated by that of a prior equitable or a subsequent legal mortgagee. If, however, the banker does not part with the title deeds and the customer is honest the risk in practice will not be great.

Advances against Life Policies

A life policy is sometimes accepted by the banker as a security for an advance, although it is not a popular security owing to the fact that it is not readily realizable. Provided, however, certain precautions are taken, it is a good security. The banker should satisfy himself that the life office concerned is a well-established and successful institution, that the policy contains no restrictive clauses, and that the amount advanced is within its surrender value. The surrender value of the policy may be obtained by a reference to the company concerned. The banker should also take into consideration that most life policies are rendered void if the assured commits suicide within twelve or thirteen months from the date of issue of the policy. He must also see that the policy does not lapse by non-payment of premiums. Further, as a contract of life insurance is one of *uberrimae fidei*, that is, of the utmost good faith, it may be rendered void if there has been any suppression of material facts by the assured concerning his life. The Indian Insurance Act of 1938 provides, however, that a life policy should not be disputed after it has been in force for two years on the ground of any misrepresentation even in respect of a material fact, except where the misrepresentation is knowingly made by the assured to defraud the insurance company.

A life policy may be taken as security in two ways, (*a*) by mere deposit with a memorandum, in which case the banker obtains an equitable mortgage, and (*b*) by a deed of assignment to the bank, which gives it a legal mortgage. While the first method is simple and cheap, it does not give a full legal title to the banker, who may also be placed in difficulty if the assured should refuse to assign the policy to the banker, when the latter considers it necessary. It is desirable therefore that the banker should have the policy assigned to him by complying with the procedure laid down for registering an assignment with the insurance company. In the case of an equitable mortgage, the banker should send the requisite notice of charge to the insurance company concerned ,

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